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MANAGEMENT OF THE DEPARTMENT OF DEFENSE

HEARINGS

BEFORE THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

PART 7

OVERSIGHT OF THE DEFENSE CONTRACT AUDIT AGENCY AND CONTRACT AUDITING PROCEDURES

MARCH 1 AND 7, 1984

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MANAGEMENT OF THE DEPARTMENT OF DEFENSE

THURSDAY, MARCH 1, 1984

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, D.C.

The committee met at 9:45 a.m., in room SD-342, Dirksen Senate Office Building, Hon. William V. Roth (chairman of the committee) presiding.

Present: Senators Roth, Percy, Eagleton, Sasser, Levin, and Bingaman.

OPENING STATEMENT OF SENATOR ROTH

Chairman ROTH. Gentlemen, please be seated. The committee will please be in order.

Today we are convening for the important purpose of holding a hearing to examine the effectiveness of contract auditing in the Department of Defense, concentrating on the management of the Defense Contract Audit Agency.

I am very angry. I was just about to cancel these hearings this morning because I just got word that the Department of Defense is muzzling one of our key witnesses. We are not going to permit that to interfere with the oversight responsibilities of the Senate Governmental Affairs Committee. There is something wrong in the State of Denmark when one of the key witnesses is not allowed to appear before us.

Now, I happen to think that based on the material I have studied that the Air Force is moving faster than any other part of the Department of Defense in trying to bring about reforms. So it deeply disturbs me when Mr. A. Ernest Fitzgerald, the Management Systems Deputy, in the Office of the Secretary of the Air Force, is given word today that he cannot appear before this committee. I am not going to take that answer as a final answer. I cannot believe that the Secretary of Defense is not going to permit a full examination of the management practices of the DCAA. If anything gives credence to the idea that there is a coverup, it's this kind of failure to permit a key witness to appear before this committee today.

I am not going to be satisfied with that kind of approach. Now, we have his statement, and we are going to release it.[1] I want to make it very clear that the statement has not been officially approved by the Air Force and that Mr. Fitzgerald has declined to appear as a private citizen. Mr. Fitzgerald was going to appear in his official capacity as the Air Force Management Systems Deputy to the Assistant Secretary of the Air Force to testify about contract labor rates, contract labor distribution problems and related contract audit support. As I said, we are going to release this unofficial statement, but I want to stress that it is not an official Air Force statement, it does not represent the Air Force position.

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[1] See p. 325.

I would just like to point out two or three things in Mr. Fitzgerald's statement that may be embarrassing to the so-called military-industrial complex. It points out that labor compensation rates are very high. I will read a few sentences:

> Our interest was reinforced in the early spring of 1983 when we received, "over the transom," a copy of a Defense Contract Administration Services compensation review at Pratt & Whitney, West Palm Beach, that showed executive compensation at that location to be 40 percent above that of their peers in other aerospace corporations.
>
> Despite the total lack of support from DCAA, our concern with overall compensation in the aerospace industry will not go away. We will have to devise ways to attack the problem without wasting further time on the DCAA.

Now, this is a statement by an expert, a man who is recognized as trying to do something in the area of making government procurement stronger and more protective of the taxpayer dollar. But I want to reemphasize that I shall ask the Secretary of Defense for permission for this man to appear before the committee. We are not going to be satisfied with this kind of so-called cooperation.

This committee was responsible for setting up an independent Inspector General, Mr. Sherick, to insure that we begin to incorporate practices and procedures that will protect the taxpayer dollar in military procurement, and we are not going to be satisfied until we see that done.

Now, let me just briefly outline this. I have a long statement, and I am not going to read the entire thing. However I want to underscore what we are trying to do here today, because it is the most important part of the defense procurement problem.

We are concentrating on the effectiveness of Government contracting. The problem, the real problem, is that we don't have enough competition in military procurement. Because we do not have competition and we are depending upon negotiations with sole-source contractors in some instances, it means that auditing is of critical importance to insure a fair price to the Government.

What we are concerned about regarding the management of the Defense Contract Audit Agency is their concern with their relationship with the contractors. As a matter of fact, you, Mr. Starrett, made such a comment to two of my investigators, although you denied it in a previous hearing.

But I think the DCAA should be the "junkyard dog" of contract auditing. It should be scrutinizing defense contracts like an unforgiving Scrooge. Its job is not, in my judgment, to be concerned about its relationship with the contractor or with the military establishment but in protecting the taxpayers' dollars.

As I said, this is not a new problem. A 1969 audit of DCAA done by the Comptroller of the Defense Department found "an excessive emphasis on the concept that DCAA is a member of the procurement team." It went on to note that this policy weakened the commitment of auditors to report significant problems concerning waste or fraud to higher levels in DOD.

Finally, the special counsel to the Merit Systems Protection Board stated, upon his office's completion of the investigation in the George Spanton case, that "evidence indicates a pervasive attitude at DCAA that reflects undue regard and solicitude for the concerns of contractors and procurement officials in the audit process."

One of the problems, one of the old problems dating back 10 or 15 years and corresponding to work done by the General Accounting Office, is that the DCAA does not have adequate access to contractor records. There is no way you can make sure in negotiating a contract that you are getting a fair price unless the auditor can determine that the cost or pricing data on which the contractor bases his bid are accurate. That means access. Access to the contractor records is important.

We find that in many cases auditors are gaining access to records, in many other instances, they are not. We have at least two contractors for the last 10 years that have refused to cooperate in making their records available, and as a result we have no real way of knowing whether their proposed contract prices are reasonable or not.

I would also like to point out, Mr. Starrett, I have several internal memoranda which indicate that DCAA did everything it could to prevent the IG from completing his oversight work of your agency in a timely manner. One DCAA official stated that he would not permit IG "fishing expeditions" and would not sit by while IG auditors went "rummaging through DCAA files." He did not want to furnish documents to the IG unless he knew how the IG was going to use them.

Another IG memorandum states, "DCAA appears to consider our review a game in which they see how much can be kept from us by providing the bare minimum of data and then only if we persist in asking for it."

Mr. Sherick, I want you to understand that the IG was created by Congress, and it was the intent of Congress that the office was to have full and complete access to any agency records they need to conduct their work. No agency head, no bureau chief, has the right to try to muzzle the work of the IG or withhold any documents from him.

My staff investigators recently reviewed DCAA operations in certain field audit locations including one in Tucson, Ariz. They found numerous deficiencies with a recent DCAA audit at the Tuscon site which are disturbing. DCAA had been asked to do a review of timekeeping practices and potential labor mischarging at a defense contractor's plant. Numerous pieces of evidence which existed before DCAA did its audit showed that labor mischarging might be occurring.

Even a prior DCAA audit found that plant employees were idle an average 27 percent of the time. According to reports by Government and company informants, employees had so much idle time that they were building Home Box Office TV receiver sets like this one here, illegally, with Government equipment and on Government time and with Government material, and then, according to the allegations, selling them for personal gain.[1]

Frankly, to the extent this was occurring, it could have substantially increased the Government price for the missiles purchased by the Army, Navy, and Air Force. The DCAA auditor himself found numerous problems in the contractor's timekeeping and labor-charging system. Yet DCAA's final audit indicated that the company's timekeeping practices and labor-charging systems were adequate.

We are not here to investigate this kind of a problem today. But we are trying to find out why DCAA is not doing a better job of providing contract audit services as they are charged to do by both statute and defense acquisition regulations.

We will be reviewing these issues today. As I said, we are not satisfied with the kind of cooperation we are getting from the Pentagon when they will not permit one of our key witnesses to appear here before us, and we shall follow through to see how that can be remedied.

[The prepared statement of Senator Roth follows:]

PREPARED STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

We convene today for a hearing to examine the effectiveness of contract auditing in the Department of Defense. Our particular focus, however, will be on the management of the Defense Contract Audit Agency.

Let me start by saying that I am concerned about the management of the Defense Contract Audit Agency operations. Since the bulk of major defense contracts are awarded without competition, DOD must thoroughly review prices proposed by contractors to insure that the Government does not accept any contracts that are not reasonably priced and supported by firm cost or pricing documentation. That is the role of DCAA, to go in with a finely chiseled pencil and analyze the prices suggested by contractors for weapon systems, spare parts and other equipment and services.

There are indications, however, that the current condition of DCAA management is poor in many areas and that it is leaving the taxpayers' defense dollar defenseless against excessive pricing and cost growth. DCAA should be the "junkyard dog" of contract auditing. It should be scrutinizing defense contracts like an unforgiving scrooge.

We want to examine allegations that DCAA is giving the procurement agencies just what they want—no more, no less. DCAA policies may be affecting the morale and intitiative of its' auditors. Ultimately, the drive to turn over every stone in an effort to eliminate waste and prevent cost growth could be affected by such policies.

I fully realize that DCAA has to participate with the contracting officers and other procurement personnel in order to assist them in negotiating fair and reasonable contracts. But acting as an equal partner in the procurement process with independent views is much different than acting as a member of the procurement "team", unwilling to question the actions of the contracting officer even when it appears that tax dollars might be misspent.

The problems at DCAA are varied and many of them have been around for a number of years. For example, DCAA's view of its role in the procurement process has been a concern to many in Congress and in DOD itself. A 1969 audit of DCAA done by the comptroller of the Defense Department found "an excessive emphasis on the concept that DCAA is a member of the procurement team. . ." The report went on to note that this policy weakened the commitment of auditors to report significant problems concerning waste or fraud to higher levels in DOD.

Even the rules implementing DCAA's own charter show this bias against questioning the decision of the contracting officer stating in part that "the contract auditor may provide assistance to the internal (IG) auditor where providing assistance does not conflict with his basic role of providing advisory services to contracting officers".

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[1] See p. 7.

Finally, the Special Counsel to the Merit Systems Protection Board stated after his investigation of certain personnel practices in DCAA that "evidence indicates a pervasive attitude at DCAA that reflects undue regard and solicitude for the concerns of contractors and procurement officials in the audit process".

I don't expect DCAA auditors to constantly beat the heads of contracting officers. But they shouldn't be at the feet of contracting officers either. Being members of the procurement "team" shouldn't mean ignoring poor management or excessive costs. DCAA's role should be to help prevent the Government from wasting the taxpayers' dollar. It should represent the interests of the taxpayer, not the contracting officer.

I am also concerned about DCAA's overall management practices. One memorandum we have received from a former DCAA auditor states that "the quality of DCAA audit reports has deteriorated dramatically over the past year or so. With increasing frequency we have found errors . . . or failure to address all concerns requested." I do not know what might have caused such mistakes but I would like to hear what management is doing to insure that similar problems are not repeated.

I am also very concerned that the DCAA may not be receiving the information it needs to properly review price proposals submitted by contractors. The access of the DCAA to contractor records is sometimes extremely limited and forces auditors to issue reports which are "qualified", meaning the auditor had too many limitations in the scope of the examination to issue a complete and meaningful report. There are indications that large numbers of DCAA audit reports are issued on a qualified basis. My investigators have been told that 90 percent or more of the reports issued in one DCAA office are qualified and a GAO report issued in 1979 found similar problems. Yet, DCAA headquarters does not keep records of how many qualified audits are issued each year, and has no way to find out where the problems are in its local audit offices.

At one large contractor, DCAA has had trouble since 1965 in getting the documents it needs. The local DCAA resident auditor notified the Agency's headquarters as recently as August of 1983 of his problems, yet nothing was done about this matter until early December of 1983, after my staff had met with DCAA headquarters staff to discuss access to records problems in DCAA. A memorandum issued by the DOD IG's staff in August of last year states that "no central file is maintained" concerning access to records problems. How can top officials in DCAA manage their agency when they have no regular source of information on access to records problems?

The Inspector General will discuss two reports today on the DCAA's problems gaining access to contractor records and its handling of fraud or mismanagement reports. I am very disturbed by the Inspector General's statement concerning the findings of these two reports. I am even more disturbed by evidence that top level DCAA management attempted to delay and inhibit the IG's investigations. I have several internal memoranda which indicate that DCAA officials did everything they could to prevent the IG from completing his work in a timely manner. One DCAA official stated that he would not permit IG "fishing expeditions" and would not sit by while IG auditors went "rummaging through DCAA files." He also stated that he did not want to furnish documents unless he knew how the IG was going to use them.

Another IG memorandum states "DCAA appears to consider our review a game in which they see how much can be kept from us by providing the bare minimum of data and then only if we persist in asking for it."

Let me just state right here that the IG's were created to have full and complete access to any agency records they need to conduct their work. DCAA's actions delayed the issuance of this report which was supposed to be made public today. No agency head or bureau chief has the right to try to muzzle the work of the IG's and only certain documents, which must be denied by statute, can be withheld.

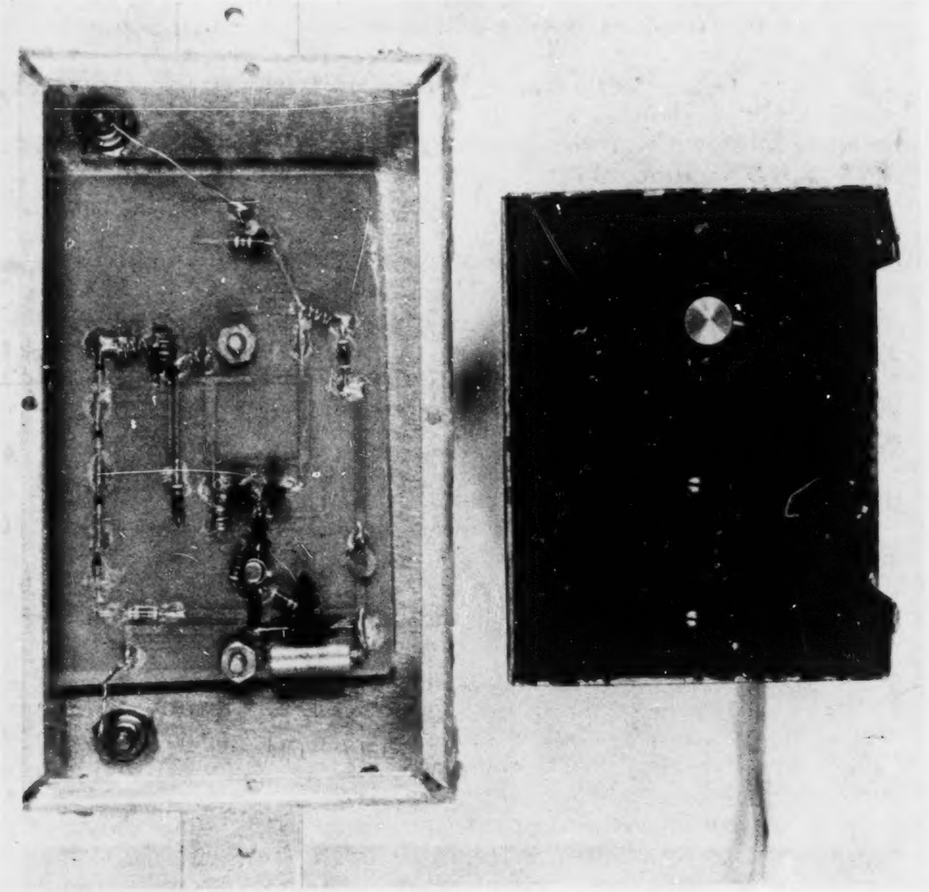
My staff investigators recently reviewed DCAA operations in several field locations including DCAA's Tucson, Ariz., audit site. They found numerous deficiencies with a recent DCAA audit which are disturbing. DCAA had been asked to do a review of potential labor mischarging at a defense contractor's plant. Numerous pieces of evidence which existed before DCAA did its audit, showed that labor mischarging might be occurring. For example, a prior DCAA audit found that plant employees were idle an average 14 percent of the time, excluding lunch time, preparation for work and other normal work breaks—a total idleness of 27 percent overall. According to reports by Government and company informants, employees had so much time on their hands that they were building HBO television receiver sets, like this one [see photograph which follows], illegally on company equipment and selling them. To the extent this practice was occurring, it would increase the Government's price for the missiles purchased from the contractor.

The DCAA auditor himself found numerous problems in the contractor's timekeeping and labor charging system. Yet, DCAA's final audit report indicated that their timekeeping practices and the contractor's labor charging system were adequate.

I hope this is not representative of DCAA's auditing work. Major problems in the contractor's operations may have been glossed over by DCAA's inadequate work, and major labor mischarging problems may have been missed. For example, there are indications that labor costs at this particular contractor's plant are 17 times as high as the engineered standards suggest are appropriate. If true, major cost growth could be occurring at this plant with little firm information on what is causing it and how to bring it under control.

We will review these and other problems during the hearing today. Based on the evidence I have seen, I am very concerned with the current condition of DCAA. The quality of DCAA audits is generally very good but uneven because all too frequently the value of its audits are reduced by qualifications in the scope of work. The Agency often does not get timely access to the records it needs. Its lack of independence from the contracting agencies is also a serious concern. Top DCAA management appears to be unaware of the potentially serious problems occurring in local audit locations and, worse yet, there are indications that it does not assist its field auditors when they need help in resolving these problems.

We hope to examine today the nature of these problems and determine what can be done to solve them. If the hearings confirm our initial findings, I fully intend to do all I can to reform DCAA's management as soon as possible. If that means putting DCAA under the IG, then I am willing to give that step serious consideration. I look forward to hearing from our witnesses.



Chairman ROTH. Senator Percy.

OPENING STATEMENT OF SENATOR PERCY

Senator PERCY. Thank you, very much, Mr. Chairman.

I guess I have served on this committee and the Permanent Subcommittee on Investigations longer than any other member, Democrat or Republican.

As long as I have been on the committee, I have never quite seen you so concerned and exercised and righteously indignant as you are, and I join you. This has been one of the most exasperating situations that I have ever faced, and I faced it after leaving the University of Chicago and coming to Bell & Howell and spending 3 years organizing their defense contracting.

Then when I went in the Navy as a procurement officer down here in Washington in the old Navy Building I was active in Naval Ordnance and Aviation, in buying the Norton bomb sight, and in supervising the production and control of the Mark 30 torpedo and other weapons. I then went out in the field for a couple of years, and spent 18 years as CEO at Bell & Howell, managing very large contracts with hundreds of suppliers on defense work.

So I have been on that end of it as well as this end of it. I think this present situation is one of the most frustrating that I have ever seen.

Now the Grace Commission comes up with a report that says there is $424 billion of waste in the Federal Government that could be eliminated with proper procedures and business-like practices in 3 years; $90 billion of that is in the Department of Defense. We have held hearings in this room on any number of situations, including shipbuilding in Mississippi, after which we received a letter of apology from the Secretary of the Navy for the sloppy practices and the procedures they didn't know were going on.

We really face a crisis now. There is going to be a lack of credibility in any defense budget, and I can tell you as one Senator, there was no way, knowing what I did from the Grace Commission even before its report came out, no way I could vote for that increase in defense spending.

I voted for a 5-percent increase, not 15 percent, and we saved $15 billion by that. Still, the President signed the bill.

I am for a strong national defense. Just the other night, the 4,500 reserve officers of the State of Illinois honored me by notifying me that I would be the "minute man" of the year, the citizen in Illinois who has done more to strengthen our national defense than any other citizen.

But while I stand for a strong defense actions like those we will describe today are weakening our defenses; they are weakening our credibility; they are weakening the ability of the Commander in Chief, the President of the United States, to get a defense bill through.

Now, we could cover them up and just say, "Well, maybe they are aberrations and maybe they are not a pattern." But the pattern is a pervasive one, and the procedure and system that is being used is a system of ripoffs of the taxpayers and of everyone in the executive branch and everyone in the Congress.

We want to back up everyone in the military who is now trying to put a finger on this. I am disappointed that one witness that we wanted to have here was apparently prohibited from testifying in his official capacity.

Mr. Chairman, you and I disclosed at a hearing of this committee that a defense contractor had offered to sell a 3-inch piece of steel wire called, right on the blueprint, an antenna motor assembly pin, for $7,500.

Two investigators on my staff took that blueprint to a local hardware and asked if they could buy that so-called assembly pin. The storekeeper took a coil of wire, a one-sixteenth of an inch wire, cut off a 3-inch piece, and said, "Here, take it." It is a giveaway item. He said it would cost him more to charge something for it than to simply give it away. So if we were able to get something for free while the Government is willing to pay $7,500, and while a contractor had the audacity to call that a high-falutin sounding name and put a bid in for $7,500—the contractor immediately withdrew the bid as soon as we disclosed what was happening, by the way—something is wrong in the Department of Defense, and we had better get to the bottom of this.

It has me thinking how much we are paying for major weapons systems. If you pay this much, $7,500 for a give-away piece of wire, what are we paying for a whole weapon system?

Are we getting our money's worth when we make expensive purchases of planes, ships, missiles and the like? With Federal deficits so high, it is essential that we ask tougher questions than ever before about Federal spending. We simply must make sure that every tax dollar is well spent, whether we are spending it on defense or anything else.

I can well remember the controller of Bell & Howell when I was president of the company—a young fellow by the name of Harold Geneen. I could only hold him there for a year. He was taken away by Jones & Loughlin, and he ended up as chairman of the board of IT&T. He made $1 million a year, and he was worth $10 million to any company. He taught me, through the years, that cost control and tight budgetary control was the way to control a company. You didn't make money, you saved money and showed a surplus at the bottom line.

For that reason, I am applying the same standards here. I know Government isn't business, but there is a business end of government that ought to be recognizable in the procedures that we use.

For that reason, I have supported and this committee has supported inspectors general going into various departments to do special auditing, rather than having us do it all the time. We don't have the staff or the time, but we just have to force ourselves to get the time when we see the job not being done adequately, or when inspectors general are not being properly backed up.

When I learned from Pentagon sources that in 1982 we may have paid Hughes Aircraft $3,404 per standard work hour for 93 Maverick missiles, I asked my staff to investigate the matter. Was this an accounting fluke, I wondered, or were the taxpayers the victims of serious waste, overcharging, and mismanagement?

It is still really too early to reach a definitive conclusion by this committee, Mr. Chairman, and that is why this hearing is very important. But the evidence is mounting in one direction.

Just look at the numbers. We learned that the hands-on machinists and laborers who did the work at Hughes' Tucson plant were typically paid between $4 and $14 an hour, including reasonable overhead and other costs. I could understand a contractor charging the Air Force $30 or $35 an hour for the work of employees like these, but $3,404? There is no possible way in any accounting procedure or system I have ever seen in all the defense plants that I have run would I have had the audacity to charge that kind of a figure.

I realize that Hughes has asserted that these were developmental missiles built for testing purposes, so they may have required some special machinery and reworking adding to their costs. But I cannot understand how each of these missiles could possibly have cost anywhere close to what they did, had this been an efficient operation.

Our investigation has uncovered some clues as to why we might have paid what we did. Take a look at the items I have with me.

Here are copies of some timecards.[1] I have gone over them in detail. They are not just any timecards, mind you.

We have been told these are copies of falsified timecards, timecards charging the taxpayers for work supposedly done but not, in fact, done at the Hughes' Tucson plant.

Here we have a home box office receiver.[2] It is made, sold, and used absolutely contrary to the law. It is an illegal product. We strongly suspect it was made at the Hughes Tucson plant by Hughes employees.

The material and time used to make this illegal device may have been charged to the taxpayer, and must be found somewhere in the accounting area of the missiles and in that $3,404 hourly charge.

Let me show you a photograph obtained by our inspectors and investigators. These are antennas on the roofs of houses. We have, for protective purposes, covered up the pictures of the house.

Both houses are the houses owned by Hughes employees. Our sources tell us several Hughes employees, including at least one executive, may have these receivers at their homes. Remember, those are receivers probably made illegally at the plant using Government time paid for by the taxpayers, and there are the antennas mounted right on the houses, including executives of Hughes.

Here we have the evidence of a problem which, in my view, goes to the root of the matter. Here are just a few examples of employment reports filed by roughly 200 retired Pentagon officials and other service personnel who have gone to work at Hughes Aircraft, almost all from the Air Force. Here are the actual Xerox copy reports of those official reports. They are not made up. They come right out of the Pentagon files.[3]

Many left the service one day and went to work at Hughes the next. In fact, there is even some overlapping; there is some indication some may still have been in the Air Force when they actually started working for the company.

I would say this is not a revolving door; this is a revolving chair, and the pattern of this kind of activity is pervasive. It has gone on over a long period of time, and the end consequences that we get from it are not a surprise.

Many of these former Pentagon officials, while in the Air Force, had key roles in developing, testing, and procuring contracts for the Maverick missile. Then they traded their service stripes for pin stripes. Now they are cashing in with big salaries at the taxpayers' expense—salaries paid, I should add, on top of generous pensions and other allowances.

What is more, their former associates, who remain at the Pentagon in positions of influence over the Maverick missile may themselves be starting to think about their retirement. They are only human; they see the rewards awaiting them if they toe the line and play the contractor's game.

Who wins this game? The contractor and the revolving door employee. Who loses? The taxpayer and everyone in this Nation who is hurt by big deficits and high interest rates.

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[1] May be found in the committee files.

[2] See p. 7.

[3] May be found in the committee files.

In summary, if we are to get the deficit down, if we are ever going to persuade taxpayers their money is well spent, if we are ever going to direct our defense dollars to where they are really needed, we have to put a stop to this practice. If illegal acts have been committed, we want to see prosecution. If nothing illegal has been done, then maybe we need to change the laws. One way or another, Mr. Chairman, this simply has to stop.

You and I know that many of our defense contractors do fine and important work. When we single out one for criticism, as I am today, I think it is only fair that we single out one for praise. I would like to insert in the hearing record an article in the Wall Street Journal, commending Rockwell, the Northrop Corp. and other contractors for their excellent work on the B-1 bomber. The B-1 is not only ahead of schedule, it is below cost.

[The article referred to follows:]

[From the Wall Street Journal, Feb. 6, 1984]

PROCUREMENT SUCCESS STORY

Waste, fraud, mismanagement. Those words have become popularly synonymous with the Pentagon procurement process. It is good, then, to be able to cite recent evidence counter to that image.

The big news Friday was that the Air Force had divided a huge jet-engine contract between General Electric and the former, exclusive contract-holder, Pratt & Whitney. The competition is expected to produce cost savings, plus a warranty system that shifts some costs for material failures back on the contractor.

Another success story also appears to be underway, involving the B-1. The B-1 bomber program, which Jimmy Carter killed and Ronald Reagan resurrected, is now two years into development and is well ahead of schedule and below cost. That's no small accomplishment for a $20.5 billion program, which some critics contended might cost nearly twice that. Much of the credit goes to an Air Force management that decided not to re-invent the wheel and to the multiyear procurement procedure that Defense Secretary Weinberger has been advancing.

The Air Force has already documented $550 million in cost savings, and the figure could reach more than $1 billion, according to Gen. William E. Thurman, who manages the B-1 program. He attributes the savings to the multiyear procurement procedure, which helps drive down unit costs by avoiding costly fits and starts in the production program. New incentives for cost savings have led, as well, to some smart engineering decisions to use available standard components, where possible, instead of designing new ones.

For instance, the B-1 will use the Air Force's standard radio equipment, and the radar will be the same one already developed for the F-16. On the other hand, the Air Force didn't spare any money on providing the B-1 with the special capabilities needed to replace the aging B-52s as America's penetrating strategic bomber; emphasis was placed on developing sophisticated computers, avionics and other electronic equipment both to protect the aircraft from enemy attack and to improve its ability to locate and destroy targets.

Contractors have been encouraged to save money under the B-1's fixed-price incentive program, under which the government and the contractors evenly split the savings when an item comes in under budget. Rockwell, the major contractor, already has saved about $500 million. At the same time, aircraft assembly is moving ahead so briskly that the first plane may be ready as soon as next fall, about six months ahead of schedule. The last of the 100 planes is due by mid-1988.

The B-1's primary function will be to strengthen the U.S. nuclear deterrence capability through its ability to penetrate Soviet air defenses and its ability to find dispersed Soviet weapons. Greater Soviet deployment of mobile missiles threatens to weaken the U.S. counterstrike capability, since it is difficult to target U.S. ballistic and cruise missiles on these weapons. But the Air Force expects that the aircraft also can function as a long-range tactical bomber, carrying either conventional bombs or "smart" guided weapons. It may well serve a special role in projecting American air power into remote areas that are too distant for our current land-based or carrier-based tactical aircraft. Some British military experts believe that the costly war over the Falkland Islands might have been averted had the British had such a long-range bomber capable of interdicting the Argentine ships and thus capable of discouraging a seaborne invasion of the islands.

The handling of the B-1 appears to point the way for all new military procurement programs, entailing less congressional disruption of year-to-year budgeting and better incentives for cost saving. It demonstrates how much room there has been for improvement and how much more military muscle this country can acquire for its money through more intelligent procurement practices.

Senator **Percy**. Both of us, every member of this committee, are for a strong national defense.

I know that you are, and I know that I am, but a dollar wasted on defense does not make the Nation any more secure.

I commend you for having this hearing this morning.

[Senator Percy's prepared statement follows:]

Prepared Statement of Senator Percy

Last fall, Mr. Chairman, you and I disclosed at a hearing of this committee that a defense contractor had offered to sell a three-inch piece of steel wire to the Air Force for $7,500. My staff was able to get a similar piece of wire from a local hardware store for free.

This got me to thinking about how much we are paying for major weapons systems. If a contractor could charge us $7,500 for a giveaway item, how do we know we're getting our money's worth when we make more expensive purchases—for planes, ships, missiles, and the like?

In times like these, with federal deficits so high, it is essential that we ask tougher questions than ever before about federal spending. We simply must make sure that every tax dollar is well-spent, whether we're spending it on defense or anything else.

When I learned from Pentagon sources that, in 1982, we may have paid Hughes Aircraft $3,404 per standard work hour for 93 Maverick missiles, I asked my staff to investigate the matter. Was this an accounting fluke, I wondered, or were the taxpayers the victim of serious waste, overcharging, and mismanagement?

It is still too early to reach conclusions about this, Mr. Chairman, but the evidence is beginning to mount. Just look at the numbers. We learned that the hands-on machinists and laborers who did the work at Hughes' Tucson plant were typically paid between $4 and $14 an hour. Including reasonable overhead and other costs, I could understand a contractor charging the Air Force $30 or $35 an hour for the work of employees like these. But $3,404?

I realize, as Hughes has asserted, that these were developmental missiles built for testing purposes, so they may have required some special machining and reworking, adding to their cost. But I cannot understand how each of these missiles could possibly have cost anywhere close to what they did, had this been an efficient operation.

Our investigation has uncovered some clues as to why we might have paid what we did. Take a look at the items on this table. Here we have some time-cards. Not just any time-cards, mind you. We have been told these are falsified time-cards—time-cards charging the taxpayers for work supposedly done, but not in fact done, on the Maverick missile.

Here we have a Home Box Office receiver. It is made, sold, and used illegally. We strongly suspect it was made at the Hughes Tucson plant, by Hughes employees. The materials and time used to make this illegal device may have been charged to the taxpayers.

Here we have a photograph of illegal HBO receivers on the TV antennas of two houses owned by Hughes employees. Our sources tell us several Hughes employees, including at least one executive, may have these receivers at their homes.

And here we have evidence of the problem which, in my view, goes to the root of the matter. Here are just a few examples of employment reports filed by roughly 200 retired Pentagon officials and other service personnel who have gone to work at Hughes Aircraft, almost all from the Air Force. Many left the service one day and went to work at Hughes the next. A few even went to Hughes before officially retiring from the Air Force. This isn't a revolving door—it's a revolving chair.

Many of these former Pentagon officials, while in the Air Force, had key roles in developing, testing, and procuring contracts for the Maverick missiles. Then they traded their service stripes for pinstripes. Now they are cashing in with big salaries at the taxpayers' expense—salaries paid, I should add, on top of generous pensions and other allowances.

What's more, their former associates who remain at the Pentagon, in positions of influence over the Maverick missile, may themselves be starting to think about their retirement. They are only human. They see the rewards awaiting them if they toe the line and play the contractor's game. Who wins this game? The contractor, and the revolving-door employee. Who loses? The taxpayer, and everyone in this nation who is hurt by big deficits and high interest rates.

If we are ever going to get the deficit down, if we are ever going to persuade taxpayers that their money is well-spent, if we are ever going to direct our defense dollars to where they are really needed, we have to put a stop to this practice. If illegal acts have been committed, I want to see prosecutions. If nothing illegal has been done, then maybe we need to change the laws. One way or another, this has to stop.

Mr. Chairman, you and I both know that many of our defense contractors do fine and important work. When we single out one for criticism, as I am today, I think it only fair that we single out another for praise. I would like to insert in this hearing record an editorial from the Wall Street Journal commending the Northrop Corporation for its excellent work on the B-1 bomber. Two years into development, Northrop is ahead of schedule and below cost.

Mr. Chairman, I'm for a strong national defense, as I know you are. But a dollar wasted on defense does not make the nation any more secure. I commend you for chairing this hearing, and I offer you my full cooperation.

Chairman ROTH. Thank you, Senator Percy.

I want to apologize to my two colleagues, Senator Sasser and Senator Bingaman. We follow the early-bird rule here, and they should have been called upon first.

I think it is the second time I have done that to you, Jim. It was an error on my part.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman.

Mr. Chairman, I want to commend you for convening these hearings this morning. I think they are urgent and most worthwhile. Today, I am introducing legislation in the U.S. Senate to abolish the Defense Contract Audit Agency. This bill will statutorily terminate the Defense Department directive which established this agency. It will transfer all of the Audit Agency's duties and responsibilities to the Office of Inspector General. I don't take this action lightly. I do it because a very serious question has been raised during the course of hearings conducted by this committee over a period of 2 years, and the question is this, simply stated: Is the Defense Contract Audit Agency institutionally capable of doing the job that it was created to do? Is this agency capable of making sure that the Department of Defense has spent or contracted the taxpayers' money for work done efficiently, fairly, and economically?

The record suggests that it is institutionally incapable of doing the job for which it was created.

Prominent among the episodes involving this agency's ineptitude, of course, is the case of George Spanton. Consider just a thumbnail sketch of this case, if you will. Here we have an auditor reporting to his superiors questionable charges of over $100 million. At first blush, one would expect this auditor to receive a commendation, a raise or promotion for disclosing waste that would lead to savings of hundreds of millions of dollars. Well, what happened?

According to one newspaper article, and I quote, "The Pentagon sent criminal investigators to check out the auditor, kept mum about his findings, lowered his job performance ratings, attempted to transfer him, then pressured him to quit."

In another account of this case, a special investigator of the Department of Defense Inspector General's Office testified that "high officials" from the Pentagon's contract audit arm, "ignored or covered up" evidence of wrongdoing while trying to fire whistle-blowing auditor George Spanton.

Now, only 6 weeks ago, it came out in the hearings involving Mr. Spanton that he pushed for a wider audit of salaries for which the Government reimburses contractors, contending that billions of dollars could be saved by so doing. What was the Defense Contract Audit Agency's response? DCAA was largely uninterested, evidence showed. Even though top levels of Defense had pointed to contractor labor rates as an area of potentially large waste, DCAA did not attempt a wider audit on its own. It became apparent to this committee that the Spanton case was typical and not unique. It became clear in the word of A. Ernest Fitzgerald, who is not with us today—and our Chairman says Mr. Fitzgerald, who was supposed to be here today—has been muzzled by the Department of Defense, and that would appear to be the case—that the Defense Contract Audit Agency regarded military contractors as "clients," that the "Defense Contract Audit Agency had come to specialize in finding no evidence of violations by contractors. It is what they do best."

Earlier, an investigator told the Permanent Subcommittee on Investigations about another episode involving DCAA. I quote that investigator: "DCAA's complacency in following up critical audits is all the more troubling in view of how easily its auditors are hoodwinked."

That was 10 months ago, and our chairman, Senator Roth, was prompted to tell the Director of the DCAA at that time, and I quote Senator Roth, "Frankly, I'm concerned about the lack of aggressiveness of your organization." Another colleague, Senator D'Amato of New York asked of the agency several months ago, and I quote Senator D'Amato, "Is there too close a relationship between the watchdog and the people it is supposed to be watching? I'm concerned that the watchdog's teeth may have been pulled." So said Senator D'Amato.

I'm concerned that this watchdog was born without any teeth. Yet another colleague, Senator Grassley of Iowa, in speaking of this, said, "The harassment and intimidation of Mr. Spanton and those who supported Mr. Spanton by giving truthful testimony," Senator Grassley went on to say, and I quote, "there is something sinister about a system which penalizes public servants who faithfully serve their society while rewarding those who contribute to corruption."

I agree with my chairman, Senator Roth, and with my colleagues, Senator Grassley and Senator D'Amato. The problem has its roots not in the personalities involved in the Spanton case; the problem is rooted in the institutional relationships in which this audit agency finds itself. The institutional reflex to avoid potentially controversial findings seems to be paramount; that is, it seems to be to avoid, to await, and to amend.

Into this setting comes the Senate Governmental Affairs Committee doing the job that it is mandated to do: oversight in Government. I am sure that some of our critics feel that they have seen and been through all of this before, and certainly they have, many times. Over a generation ago, another Senator from Missouri chaired the Senate Committee to Investigate the National Defense program. That Senator's name was Harry S. Truman. Old Harry said, and I quote, "It's a crime and a disgrace. I'll bet you billions of dollars are being wasted over there at the Pentagon, and it's not right," so said Harry, "to have all those people in one building without a single watchdog."

Well, that's our job here on this committee, and the chairman of this committee has done this job well, and I commend him for it. So has our ranking minority member, Senator Eagleton, and it is the chairman and Senator Eagleton, more than anyone else, who had led the fight 6 years ago to establish the Office of Inspector General. That was the chairman's legislation, and that is the framework for my legislative initiative today.

But I want to emphasize that the abolition of the Defense Contract Audit Agency and the restructuring of the investigative and audit functions at the Defense Department will not end this inquiry into the way the Department of Defense or any other Federal agency manages its work or spends its money.

That is the job of this committee, oversight of our Government, and I welcome it, and I'm sure our chairman does, likewise.

Thank you, Mr. Chairman.

[Senator Sasser's prepared statement, with attachments, follow:]

SENATOR JIM SASSER

"Abolish the Defense Contract Audit Agency"

Statement

Hearing of the Senate Governmental Affairs Committee

March 1, 1984

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Today I am introducing legislation in the United States Senate to abolish the Defense Contract Audit Agency (DCAA). This bill will statutorily terminate the Defense Department directive which established the agency. It will transfer all of this audit agency's duties and responsibilities to the Office of the Inspector General.

I do not take such action lightly. I do it because a serious question has been raised during the course of hearings conducted by this committee over the past two years: That is, is the DCAA institutionally incapable of doing the job it is supposed to to do? Is it making sure that the Department of Defense has spent or contracted its money -- or is about to spend or contract -- its money for work done efficiently, fairly and economically? The record suggests that it is not doing its job.

Prominent among the episodes involving this agency is, of course, the case of George Spanton. Consider just a thumbnail sketch of that case. Here we have an auditor reporting to his superiors questionable charges of over a hundred million dollars.

At first blush, one would expect him to receive a cash award for disclosing waste that could lead to savings for the government. What really happened? According to one newspaper article: "The Pentagon sent criminal investigators to check out the auditor, kept mum about his findings, lowered his job performance ratings, attempted to transfer him, then pressured him to quit."{1} Some reward.

In another account on this case, a special investigator for the Defense Departments Inspector General's Office testified that "high officials of the Pentagon's audit arm 'ignored or covered up'evidence of crimes while trying to fire whistleblowing auditor George Spanton."{2}

Only six weeks ago, it came out in the hearing involving Mr. Spanton and his superiors that he had pushed for a wider audit of salaries for which the government reimburses contractors, contending that billions of dollars could be saved. What was the agency's response? "DCAA was largely uninterested, evidence showed, even though top levels of

Defense had pointed to contractor labor rates as an area of potentially large waste. DCAA did not attempt a wider audit on its own ..."{3}

It became apparent to this committee, however, that the Spanton case was symptomatic, not unique.

It became clear that -- in the words of Ernest Fitzgerald, who is with us here today, that the DCAA regarded military contractors as "clients," that "The Defense Contract Audit Agency has come to specialize ... in finding no evidence of violations by contractors ...It is what they do best."{4}

Earlier an investigator told the Permanent Subcommittee on Investigations about another episode involving DCAA. "DCAA's complacency (in following up critical audits) is all the more troubling in view of how easily its auditors can be hoodwinked ..."{5}

That was ten months ago. My colleague, Senator Roth, who also chairs that subcommittee, was prompted to tell the chairman of the DCAA at that time: "Frankly, I'm concerned about the lack of aggressiveness of your organization." {6}

Another colleague, Senator D'Amato, asked of the agency several months later "Is there too close a relationship between the watchdog and the people he is supposed to be watching? ... I am concerned that the watchdog's teeth may have been pulled." {7}

And yet another colleague, Senator Grassley, in speaking of the "harrassment and intimidation of Mr. Spanton and those who supported Mr. Spanton by giving truthful testimony," said "There is something sinister about a system which penalizes public servants who faithfully serve their society, while rewarding those who contributed to corruption."{8}

Well, I agree with Chairman Roth, and with my colleagues, Senator Grassley and Senator D'Amatao.

The problem has its roots not in the personalities involved in the Spanton case. The problem is rooted in the institutional relationships in which this audit agency finds itself. The institutional reflex to a critical or potentially controversial finding seems to be: avoid, await or amend.

Into this setting, comes the Senate Governmental Affairs Committee doing its job of oversight. Some critics feel that they've been through all of this before. And they're right. Over a generation ago, another Senator from Missouri chaired The Senate Committee to Investigate the National Defense Program. Some 20 years later that Senator -- Harry S. Truman -- said "It's a crime and a disgrace. I'll bet you billions of dollars are being wasted over there at the Pentagon ... It's not right, "he said, "to have all those people in one building without a single watchdog."{9}

That's our job. The Chairman of this committee has done this job well. And so has the ranking minority member. It was he, more than anyone else, who led the fight six years ago to establish the Office of Inspector General -- the framework for my legislative initiative today.

The work of Senators Roth and Senator Eagleton makes my legislation plausible, possible and, I hope, probable. But I want to emphasize that the abolition of the Defense Contract Audit Agency, and the restructuring of investigative and audit functions at the Defense Department, will not end this inquiry into the way DoD -- or any federal agency -- manages and spends its money. This is is our job. It will always be our job. And I, for one, do not shrink from that responsibility; I welcome it.

(end)

NOTES

{1} The Washington Post, December 19, 1983.

{2} John Batson, quoted by The Washington Times, December 12, 1983.

{3} Federal Times, January 23, 1984.

{4} Quoted by New York Times, November 15, 1983.

{5} Rod Smith, quoted by Associated Press, May 3, 1983.

{6} Quoted by Associated Press, May 4, 1983.

{7} Quoted by Associated Press, August 5, 1983.

{8} Quoted by Washington Times, December 1, 1983.

{9} Quoted in Plain Speaking: An Oral Biography of Harry S. Truman (Paperback) Merle Miller (New York: Berkley Publishing, 1973), p. 180.

The Defense Contract Audit Agency Abolition Act of 1984

Section-by-Section Analysis

PURPOSE: This bill would amend the Inspector General Act of 1978 (PL 95-452), as amended, to transfer to the Office of the Inspector General of the Department of Defense (DoD) the functions of the Defense Contract Audit Agency (DCAA), and for other purposes.

SECTION ONE, TITLE: The bill is called the Defense Contract Audit Agency Abolition Act of 1984.

SECTION TWO, DUTIES AND RESPONSIBILITIES: As a consequence of amending the Inspector General Act of 1978 through the transfer of DCAA duties and responsibilities, the DoD Inspector General's Office will: perform all necessary audits of contracts for DoD; furnish accounting and financial advisory services regarding contracts and subcontracts to DoD agencies and divisions which are responsible for the administration of contracts.

When and where appropriate, the DoD Inspector General will furnish financial information and advice on proposed or existing contracts and on contractors to DoD personnel responsible for procurement and contract administration; examine reimbursement vouchers DoD receives from contractors under cost type contracts, determine whether such vouchers should be approved, transmit each voucher approved for payment to the appropriate disbursing officer in DoD, and issue to the persons concerned an appropriate notice with respect to costs claimed but not allowable; furnish to procurement and contract employees advice and recommendations relating to costs incurred through different kinds of contracts; assist procurement and contract personnel in surveys of purchasing and procurement systems of the major contractors of DoD; direct audit reports to the officers or employees of the U.S. Government who have the authority to take action on the audit findings and recommendations; cooperate with appropriate components of

DoD on reviews, audits analyses or inquiries involving the financial position or financial and accounting policies, procedures and practices of contractors; and audit, and examine or review contractors' and subcontractors' accounts, documents, systems of internal control and other records, as well as accounting, costing and general buisiness practices and procedures whenever appropriate.

Most of the preceding duties and responsibilities stem from the statutory mandates devolving from the Truth in Negotiation Act (PL 87-653) or reflect standard audit and investigative duties for an Office of Inspector General. This bill further incorporates duties and responsibilities contained in DoD Directive 5105.36 (which replaced the cancelled 9 June 1965 DoD Directive 5105.36) of June 8, 1978, establishing the DCAA. These duties and responsibilities go beyond standard audit and investigative duties by calling upon the DoD Inspector General's office to play a greater role in procurement policy.

Thus, the DoD Inspector General is directed to: designate and assign personnel to be liaison auditors at appropriate major procuring and contract administration offices of DoD; review General Accounting Office (GAO) reports on DoD and any proposed DoD responses to these reports in order to ensure the validity of the material facts in the reports and responses; when and where appropriate, attend meetings, including contract negotiations, in which contract cost matters, audit reports, or related financial matters are under consideration and furnish advice to DoD personnel on such matters; and provide assistance, when requested, in the development of policies and regulations relating to DoD procurement.

The DoD Inspector General is also called upon to perform such other functions as were assigned to the DCAA on the effective date of this legislation.

SECTION THREE, AMENDING PUBLIC LAW 95-452: The DCAA is incorporated into the list of agencies whose responsibilities and duties were assumed by the DoD Inspector General's Office when the Inspector General Act of 1978 was amendedby PL97-252, the Fiscal Year 1982 DoD authorization bill.

SECTION FOUR, TERMINATION OF DCAA: The DCAA, established by DoD Directive 5105.36, June 8, 1978, is terminated.

EFFECTIVE DATE: This Act and the amendments made by the Defense Contract Audit Agency Abolition Act of 1984 shall take effect on October 1, 1985.

079826.048 S.L.C.

98th CONGRESS
2d Session

S. _____

IN THE SENATE OF THE UNITED STATES

Mr. Sasser introduced the following bill; which was read twice and referred to the Committee on ______________________

A BILL

To amend the Inspector General Act of 1978 to transfer to the Office of the Inspector General of the Department of Defense the functions of the Defense Contract Audit Agency, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the ''Defense Contract Audit Agency Abolition Act of 1984''.

Sec. 2. (a) Subsection (c) of section 8 of the Inspector General Act of 1978 (5 U.S.C. App.) is amended--

(1) by striking out ''and'' at the end of clause (8);

(2) by striking out the period at the end of clause (9) and inserting in lieu thereof a semicolon and ''and''; and

(3) by adding at the end thereof the following new clause:

''(10) in connection with the negotiation, administration, and settlement of contracts by the Department of Defense and subcontracts under such contracts, perform all necessary audits of contracts for the Department and furnish accounting and financial advisory services regarding contracts and subcontracts to all components of the Department that are responsible for procurement and the administration of contracts.''.

(b) Such section is further amended--

(1) by redesignating subsections (d), (e), (f), and (g) as subsections (f), (g), (h), and (i) respectively; and

(2) by inserting after subsection (c) the following new subsections (d) and (e):

''(d) In carrying out the duties and responsibilities provided in subsection (c) (10), the Inspector General shall--

''(1) when appropiate, furnish financial information and advice on proposed or existing contracts and on contractors to Department of Defense personnel who are responsible for procurement and contract administration;

''(2) examine reimbursement vouchers the Department receives from contractors under cost type contracts, determine whether such vouchers should be approved, transmit each voucher approved for payment to the appropriate disbursing officer of the Department, and issue to the persons concerned an appropriate notice with respect to costs claimed but not considered allowable;

''(3) furnish to procurement and contract administration personnel of the Department advice and recommendations relating to--

''(A) the acceptability of costs incurred under redeterminable, incentive, and similar type contracts;

''(B) the acceptability of costs which are incurred or are estimated to be incurred in connection with the award, negotiation, modification, change, administration, termination, or settlement of any contract of the Department;

''(C) the adequacy of the financial or accounting aspects of contract provisions; and

''(D) the adequacy of contractors' accounting and financial management systems, estimating procedures, and property controls;

''(4) assist procurement and contract administration personnel of the Department in surveys of the purchasing and procurement systems of major contractors of the Department;

''(5) direct audit reports to the officers or employees of the Government who have the authority and responsibility to take action on the audit findings and recommendations;

''(6) cooperate with appropriate components of the Department on reviews, audits, analyses, or inquiries involving contractors' financial position or financial and accounting policies, procedures, or practices;

''(7) designate and assign personnel to be liaison auditors at appropriate major procuring and contract administration offices of the Department;

''(8) review--

''(A) reports of the General Accounting Office involving significant activities under any contract of the Department of Defense or activities of any contractor with the Department; and

''(B) the proposed responses of the Department to such reports,

for the purpose of assuring the validity of the material facts contained in such reports and responses;

''(9) when appropriate, attend meetings, including contract negotiations, in which contract cost matters, audit reports, or related financial matters are under consideration and furnish advice to Department of Defense personnel on such matters;

''(10) provide assistance, when requested, in the development of policies and regulations relating to procurement by the Department of Defense;

''(11) audit, examine, or review contractors' and subcontractors'--

''(A) accounts, documents, and other records;

''(B) systems of internal control; and

''(C) accounting, costing, and general business practices and procedures;

whenever appropriate in performing a duty provided in this subsection; and

''(12) perform such other functions as were assigned to the Defense Contract Audit Agency on the effective date of the Defense Contract Audit Agency Abolition Act of 1984.

''(e) (1) The military departments and other components of the Department of Defense shall furnish to the Inspector General of the Department such support as the Inspector General considers necessary to carry out the duties and responsibilities set out in subsections (c) and (d).

''(2) Procurement and contract administration activities of the each component of the Department of Defense shall utilize the audit services of the Inspector General of the Department in connection with the negotiation, administration, and settlement of contract payments and prices involving incurred or estimated costs or cost analysis.''.

Sec. 3. Section 9 (a) (1) (C) of the Inspector General Act of 1978 (5 U.S.C. App.) is amended by inserting '', 'Defense Contract Audit Agency' , '' after ''Defense Audit Service''.

Sec. 4. The Defense Contract Audit Agency established under Department of Defense Directive 5105.36, dated June 8, 1978, is terminated.

Sec. 5. This Act and the amendments made by this Act shall take effect October 1, 1985.

INSPECTOR GENERAL ACT OF 1978

Pub. L. 95-452, Oct. 12, 1978, 92 Stat. 1101, as amended by Pub. L. 96-88, title V, § 508(n), Oct. 17, 1979, 93 Stat. 694; Pub. L. 97-113, title VII, § 705, Dec. 29, 1981, 95 Stat. 1544; Pub. L. 97-252, title XI, § 1117(a)-(c), Sept. 8, 1982, 96 Stat. 750-752

§ 1. Short title

This Act be cited as the "Inspector General Act of 1978".

ACT REFERRED TO IN OTHER SECTIONS

The Inspector General Act of 1978 is referred to in title 20 sections 3412, 3422.

§ 2. Purpose and establishment of Offices of Inspector General; departments and agencies involved

In order to create independent and objective units—

(1) to conduct and supervise audits and investigations relating to programs and operations of the Department of Agriculture, the Department of Commerce, the Department of Defense, the Department of Education, the Department of Housing and Urban Development, the Department of the Interior, the Department of Labor, the Department of Transportation, the Agency for International Development, the Community Services Administration, the Environmental Protection Agency, the General Services Administration, the National Aeronautics and Space Administration, the Small Business Administration, and the Veterans' Administration;

(2) to provide leadership and coordination and recommend policies for activities designed (A) to promote economy, efficiency, and effectiveness in the administration of, and (B) to prevent and detect fraud and abuse in, such programs and operations; and

(3) to provide a means for keeping the head of the establishment and the Congress fully and currently informed about problems and deficiencies relating to the administration of such programs and operations and the necessity for and progress of corrective action;

thereby [1] is hereby established in each of such establishments an office of Inspector General.

(As amended Pub. L. 96-88, title V, § 508(n)(1), Oct. 17, 1979, 93 Stat. 694; Pub. L. 97-113, title VII, § 705(a)(1), Dec. 29, 1981, 95 Stat. 1544; Pub. L. 97-252, title XI, § 1117(a)(1), Sept. 8, 1982, 96 Stat. 750.)

AMENDMENTS

1982—Par. (1). Pub. L. 97-252, § 1117(a)(1), inserted "the Department of Defense," following "Commerce,".

1981—Par. (1). Pub. L. 97-113 inserted "the Agency for International Development," after "Transportation,".

1979—Par. (1). Pub. L. 96-44 inserted "the Department of Education," following "Commerce,".

EFFECTIVE DATE OF 1979 AMENDMENT

Amendment by Pub. L. 96-88, effective May 4, 1980, with specified exceptions, see section 601 of Pub. L. 96-88, set out as an Effective Date note under section 3401 of Title 20, Education.

§ 3. Appointment of Inspector General; supervision; removal; political activities; appointment of Assistant Inspector General for Auditing and Assistant Inspector General for Investigations

(a) There shall be at the head of each Office an Inspector General who shall be appointed by the President, by and with the advice and consent of the Senate, without regard to political affiliation and solely on the basis of integrity and demonstrated ability in accounting, auditing, financial analysis, law, management analysis, public administration, or investigations. Each Inspector General shall report to and be under the general supervision of the head of the establishment involved or, to the extent such authority is delegated, the officer next in rank below such head, but shall not report to, or be subject to supervision by, any other officer of such establishment. Neither the head of the establishment nor the officer next in rank below such head shall prevent or prohibit the Inspector General from initiating, carrying out, or completing any audit or investigation, or from issuing any subpena during the course of any audit or investigation.

(b) An Inspector General may be removed from office by the President. The President shall communicate the reasons for any such removal to both Houses of Congress.

(c) For the purposes of section 7324 of title 5, United States Code, no Inspector General shall be considered to be an employee who determines policies to be pursued by the United States in the nationwide administration of Federal laws.

(d) Each Inspector General shall, in accordance with applicable laws and regulations governing the civil service—

(1) appoint an Assistant Inspector General for Auditing who shall have the responsibility for supervising the performance of auditing activities relating to programs and operations of the establishment, and

(2) appoint an Assistant Inspector General for Investigations who shall have the responsibility for supervising the performance of in-

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[1] So in original. Probably should be "there".

vestigative activities relating to such programs and operations.

§ 4. Duties and responsibilities; report of criminal violations to Attorney General

(a) It shall be the duty and responsibility of each Inspector General, with respect to the establishment within which his Office is established—

(1) to provide policy direction for and to conduct, supervise, and coordinate audits and investigations relating to the programs and operations of such establishment;

(2) to review existing and proposed legislation and regulations relating to programs and operations of such establishment and to make recommendations in the semiannual reports required by section 5(a) concerning the impact of such legislation or regulations on the economy and efficiency in the administration of programs and operations administered or financed by such establishment or the prevention and detection of fraud and abuse in such programs and operations;

(3) to recommend policies for, and to conduct, supervise, or coordinate other activities carried out or financed by such establishment for the purpose of promoting economy and efficiency in the administration of, or preventing and detecting fraud and abuse in, its programs and operations;

(4) to recommend policies for, and to conduct, supervise, or coordinate relationships between such establishment and other Federal agencies, State and local governmental agencies, and nongovernmental entities with respect to (A) all matters relating to the promotion of economy and efficiency in the administration of, or the prevention and detection of fraud and abuse in, programs and operations administered or financed by such establishment, or (B) the identification and prosecution of participants in such fraud or abuse; and

(5) to keep the head of such establishment and the Congress fully and currently informed, by means of the reports required by section 5 and otherwise, concerning fraud and other serious problems, abuses, and deficiencies relating to the administration of programs and operations administered or financed by such establishment, to recommend corrective action concerning such problems, abuses, and deficiencies, and to report on the progress made in implementing such corrective action.

(b) In carrying out the responsibilities specified in subsection (a)(1), each Inspector General shall—

(1) comply with standards established by the Comptroller General of the United States for audits of Federal establishments, organizations, programs, activities, and functions;

(2) establish guidelines for determining when it shall be appropriate to use non-Federal auditors; and

(3) take appropriate steps to assure that any work performed by non-Federal auditors complies with the standards established by the Comptroller General as described in paragraph (1).

(c) In carrying out the duties and responsibilities established under this Act, each Inspector General shall give particular regard to the activities of the Comptroller General of the United States with a view toward avoiding duplication and insuring effective coordination and cooperation.

(d) In carrying out the duties and responsibilities established under this Act, each Inspector General shall report expeditiously to the Attorney General whenever the Inspector General has reasonable grounds to believe there has been a violation of Federal criminal law.

§ 5. Semiannual reports; transmittal to Congress; availability to public; immediate report on serious or flagrant problems

(a) Each Inspector General shall, not later than April 30 and October 31 of each year, prepare semiannual reports summarizing the activities of the Office during the immediately preceding six-month periods ending March 31 and September 30. Such reports shall include, but need not be limited to—

(1) a description of significant problems, abuses, and deficiencies relating to the administration of programs and operations of such establishment disclosed by such activities during the reporting period;

(2) a description of the recommendations for corrective action made by the Office during the reporting period with respect to significant problems, abuses, or deficiencies identified pursuant to paragraph (1);

(3) an identification of each significant recommendation described in previous semiannual reports on which corrective action has not been completed;

(4) a summary of matters referred to prosecutive authorities and the prosecutions and convictions which have resulted;

(5) a summary of each report made to the head of the establishment under section 6(b)(2) during the reporting period; and

(6) a listing of each audit report completed by the Office during the reporting period.

(b) Semiannual reports of each Inspector General shall be furnished to the head of the establishment involved not later than April 30 and October 31 of each year and shall be transmitted by such head to the appropriate committees or subcommittees of the Congress within thirty days after receipt of the report, together with a report by the head of the establishment containing any comments such head deems appropriate.

(c) Within sixty days of the transmission of the semiannual reports of each Inspector General to the Congress, the head of each establishment shall make copies of such report available to the public upon request and at a reasonable cost.

(d) Each Inspector General shall report immediately to the head of the establishment involved whenever the Inspector General becomes aware of particularly serious or flagrant problems, abuses, or deficiencies relating to the administration of programs and operations of such establishment. The head of the establishment shall transmit any such report to the appropriate committees or subcommittees of Congress within seven calendar days, together with a report by the head of the establishment containing any comments such head deems appropriate.

(e)(1) Nothing in this section shall be construed to authorize the public disclosure of information which is—

(A) specifically prohibited from disclosure by any other provision of law;

(B) specifically required by Executive order to be protected from disclosure in the interest of national defense or national security or in the conduct of foreign affairs; or

(C) a part of an ongoing criminal investigation.

(2) Notwithstanding paragraph (1)(C), any report under this section may be disclosed to the public in a form which includes information with respect to a part of an ongoing criminal investigation if such information has been included in a public record.

(3) Nothing in this section or in any other provision of this Act shall be construed to authorize or permit the withholding of information from the Congress, or from any committee or subcommittee thereof.

(As amended Pub. L. 97-252, title XI, § 1117(c), Sept. 8, 1982, 96 Stat. 752.)

Amendments

1982—Subsec. (e). Pub. L. 97-252 added subsec. (e).

§ 6. Authority of Inspector General; information and assistance from Federal agencies; unreasonable refusal; office space and equipment

(a) In addition to the authority otherwise provided by this Act, each Inspector General, in carrying out the provisions of this Act, is authorized—

(1) to have access to all records, reports, audits, reviews, documents, papers, recommendations, or other material available to the applicable establishment which relate to programs and operations with respect to which that Inspector General has responsibilities under this Act;

(2) to make such investigations and reports relating to the administration of the programs and operations of the applicable establishment as are, in the judgment of the Inspector General, necessary or desirable;

(3) to request such information or assistance as may be necessary for carrying out the duties and responsibilities provided by this Act from any Federal, State, or local governmental agency or unit thereof;

(4) to require by subpena the production of all information, documents, reports, answers, records, accounts, papers, and other data and documentary evidence necessary in the performance of the functions assigned by this Act, which subpena, in the case of contumacy or refusal to obey, shall be enforceable by order of any appropriate United States district court: *Provided*, That procedures other than subpenas shall be used by the Inspector General to obtain documents and information from Federal agencies;

(5) to have direct and prompt access to the head of the establishment involved when necessary for any purpose pertaining to the performance of functions and responsibilities under this Act;

(6) to select, appoint, and employ such officers and employees as may be necessary for carrying out the functions, powers, and duties of the Office subject to the provisions of title 5, United States Code, governing appointments in the competitive service, and the provisions of chapter 51 and subchapter III of chapter 53 of such title relating to classification and General Schedule pay rates;

(7) to obtain services as authorized by section 3109 of title 5, United States Code, at daily rates not to exceed the equivalent rate prescribed for grade GS-18 of the General Schedule by section 5332 of title 5, United States Code; and

(8) to the extent and in such amounts as may be provided in advance by appropriations Acts, to enter into contracts and other arrangements for audits, studies, analyses, and other services with public agencies and with private persons, and to make such payments as may be necessary to carry out the provisions of this Act.

(b)(1) Upon request of an Inspector General for information or assistance under subsection (a)(3), the head of any Federal agency involved shall, insofar as is practicable and not in contravention of any existing statutory restriction or regulation of the Federal agency from which the information is requested, furnish to such Inspector General, or to an authorized designee, such information or assistance.

(2) Whenever information or assistance requested under subsection (a)(1) or (a)(3) is, in the judgment of an Inspector General, unreasonably refused or not provided, the Inspector General shall report the circumstances to the head of the establishment involved without delay.

(c) Each head of an establishment shall provide the Office within such establishment with appropriate and adequate office space at central and field office locations of such establishment, together with such equipment, office supplies, and communications facilities and services as may be necessary for the operation of such offices, and shall provide necessary maintenance services for such offices and the equipment and facilities located therein.

Section Referred to in Other Sections

This section is referred to in title 22 section 3929.

§ 7. Complaints by employees; disclosure of identity; reprisals

(a) The Inspector General may receive and investigate complaints or information from an employee of the establishment concerning the possible existence of an activity constituting a violation of law, rules, or regulations, or mismanagement, gross waste of funds, abuse of authority or a substantial and specific danger to the public health and safety.

(b) The Inspector General shall not, after receipt of a complaint or information from an employee, disclose the identity of the employee without the consent of the employee, unless the Inspector General determines such disclosure is unavoidable during the course of the investigation.

(c) Any employee who has authority to take, direct others to take, recommend, or approve any personnel action, shall not, with respect to such authority, take or threaten to take any action against any employee as a reprisal for making a complaint or disclosing information to an Inspector General, unless the complaint was made or the information disclosed with the knowledge that it was false or with willful disregard for its truth or falsity.

§ 8. Additional provisions with respect to the Inspector General of the Department of Defense

(a) No member of the Armed Forces, active or reserve, shall be appointed Inspector General of the Department of Defense.

(b)(1) Notwithstanding the last two sentences of section 3(a), the Inspector General shall be under the authority, direction, and control of the Secretary of Defense with respect to audits or investigations, or the issuance of subpoenas, which require access to information concerning—

(A) sensitive operational plans;

(B) intelligence matters;

(C) counterintelligence matters;

(D) ongoing criminal investigations by other administrative units of the Department of Defense related to national security; or

(E) other matters the disclosure of which would constitute a serious threat to national security.

(2) With respect to the information described in paragraph (1) the Secretary of Defense may prohibit the Inspector General from initiating, carrying out, or completing any audit or investigation, or from issuing any subpoena, after the Inspector General has decided to initiate, carry out or complete such audit or investigation or to issue such subpoena, if the Secretary determines that such prohibition is necessary to preserve the national security interests of the United States.

(3) If the Secretary of Defense exercises any power under paragraph (1) or (2), the Inspector General shall submit a statement concerning such exercise within thirty days to the Committees on Armed Services and Governmental Affairs of the Senate and the Committees on Armed Services and Government Operations of the House of Representatives and to other appropriate committees or subcommittees of the Congress.

(4) The Secretary shall, within thirty days after submission of a statement under paragraph (3), transmit a statement of the reasons for the exercise of power under paragraph (1) or (2) to the Committees on Armed Services and Governmental Affairs of the Senate and the Committees on Armed Services and Government Operations of the House of Representatives and to other appropriate committees or subcommittees.

(c) In addition to the other duties and responsibilities specified in this Act, the Inspector General of the Department of Defense shall—

(1) be the principal adviser to the Secretary of Defense for matters relating to the prevention and detection of fraud, waste, and abuse in the programs and operations of the Department;

(2) initiate, conduct, and supervise such audits and investigations in the Department of Defense (including the military departments) as the Inspector General considers appropriate;

(3) provide policy direction for audits and investigations relating to fraud, waste, and abuse and program effectiveness;

(4) investigate fraud, waste, and abuse uncovered as a result of other contract and internal audits, as the Inspector General considers appropriate;

(5) develop policy, monitor and evaluate program performance, and provide guidance with respect to all Department activities relating to criminal investigation programs;

(6) monitor and evaluate the adherence of Department auditors to internal audit, contract audit, and internal review principles, policies, and procedures;

(7) develop policy, evaluate program performance, and monitor actions taken by all components of the Department in response to contract audits, internal audits, internal review reports, and audits conducted by the Comptroller General of the United States;

(8) request assistance as needed from other audit, inspection, and investigative units of the Department of Defense (including military departments); and

(9) give particular regard to the activities of the internal audit, inspection, and investigative units of the military departments with a view toward avoiding duplication and insuring effective coordination and cooperation.

(d) Notwithstanding section 4(d), the Inspector General of the Department of Defense shall expeditiously report suspected or alleged violations of chapter 47 of title 10, United States Code (Uniform Code of Military Justice), to the Secretary of the military department concerned or the Secretary of Defense.

(e) For the purposes of section 7, a member of the Armed Forces shall be deemed to be an employee of the Department of Defense.

(f)(1) Each semiannual report prepared by the Inspector General of the Department of Defense under section 5(a) shall include information concerning the numbers and types of contract audits conducted by the Department during the reporting period. Each such report shall be transmitted by the Secretary of Defense to the Committees on Armed Services and Governmental Affairs of the Senate and the Committees on Armed Services and Government Operations of the House of Representatives and to other appropriate committees or subcommittees of the Congress.

(2) Any report required to be transmitted by the Secretary of Defense to the appropriate committees or subcommittees of the Congress under section 5(d) shall also be transmitted,

within the seven-day period specified in such section, to the Committees on Armed Services and Governmental Affairs of the Senate and the Committees on Armed Services and Government Operations of the House of Representatives.

(g) The provisions of section 1385 of title 18, United States Code, shall not apply to audits and investigations conducted by, under the direction of, or at the request of the Inspector General of the Department of Defense to carry out the purposes of this Act.

(As amended Pub. L. 97-252, title XI, § 1117(b), Sept. 8, 1982, 96 Stat. 751.)

AMENDMENTS

1982—Pub. L. 97-252 amended section generally, substituting additional provisions relating to the Inspector General of the Department of Defense for provisions relating to semiannual reports of Secretary of Defense on audit, investigative, and inspection units of Defense Department, availability of such reports to the public, exclusion of national security material, delegation of the Secretary's duties, submittal of proposed legislation, the establishment of a task force to study operation of audit, investigative and inspection units, membership in the task force, and the submission of a comprehensive report by the task force to the Secretary of Defense and Director of Office of Management and Budget, who were to submit a final report to Congress not later than April 1, 1980.

§ 8A. Special provisions relating to the Agency for International Development

(a) In addition to the other duties and responsibilities specified in this Act, the Inspector General of the Agency for International Development—

(1) shall supervise, direct, and control all security activities relating to the programs and operations of that Agency, subject to the supervision of the Administrator of that Agency; and

(2) to the extent requested by the Director of the United States International Development Cooperation Agency (after consultation with the Administrator of the Agency for International Development), shall supervise, direct, and control all audit, investigative, and security activities relating to programs and operations within the United States International Development Cooperation Agency.

(b) In addition to the Assistant Inspector Generals provided for in section 3(d) of this Act, the Inspector General of the Agency for International Development shall, in accordance with applicable laws and regulations governing the civil service, appoint an Assistant Inspector General for Security who shall have the responsibility for supervising the performance of security activities relating to programs and operations of the Agency for International Development.

(c) The semiannual reports required to be submitted to the Administrator of the Agency for International Development pursuant to section 5(b) of this Act shall also be submitted to the Director of the United States International Development Cooperation Agency.

(d) In addition to the officers and employees provided for in section 6(a)(6) of this Act, members of the Foreign Service may, at the request of the Inspector General of the Agency for International Development, be assigned as employees of the Inspector General. Members of the Foreign Service so assigned shall be responsible solely to the Inspector General, and the Inspector General (or his or her designee) shall prepare the performance evaluation reports for such members.

(e) In establishing and staffing field offices pursuant to section 6(c) of this Act, the Administrator of the Agency for International Development shall not be bound by overseas personnel ceilings established under the Monitoring Overseas Direct Employment policy.

(f) The reference in section 7(a) of this Act to an employee of the establishment shall, with respect to the Inspector General of the Agency for International Development, be construed to include an employee of or under the United States International Development Cooperation Agency.

(g) The Inspector General of the Agency for International Development shall be in addition to the officers provided for in section 624(a) of the Foreign Assistance Act of 1961 [22 U.S.C. 2384(a)].

(h) As used in this Act, the term "Agency for International Development" includes any successor agency primarily responsible for administering part I of the Foreign Assistance Act of 1961 [22 U.S.C. 2151 et seq.].

(Added Pub. L. 97-113, title VII, § 705(a)(3), Dec. 29, 1981, 95 Stat. 1544.)

REFERENCES IN TEXT

The Foreign Assistance Act of 1961, referred to in subsec. (h), is Pub. L. 87-195, Sept. 4, 1961, 75 Stat. 424, as amended. Part I of the Foreign Assistance Act of 1961 is classified generally to subchapter I (§ 2151 et seq.) of chapter 32 of Title 22, Foreign Relations and Intercourse. For complete classification of this Act to the Code, see Short Title note set out under section 2151 of Title 22 and Tables.

§ 9. Transfer of functions

(a) There shall be transferred—

(1) to the Office of Inspector General—

(A) of the Department of Agriculture, the offices of that department referred to as the "Office of Investigation" and the "Office of Audit";

(B) of the Department of Commerce, the offices of that department referred to as the "Office of Audits" and the "Investigations and Inspections Staff" and that portion of the office referred to as the "Office of Investigations and Security" which has responsibility for investigation of alleged criminal violations and program abuse;

(C) of the Department of Defense, the offices of that department referred to as the "Defense Audit Service" and the "Office of Inspector General, Defense Logistics Agency", and that portion of the office of that department referred to as the "Defense Investigative Service" which has responsibility for the investigation of alleged criminal violations;

(D) of the Department of Education, all functions of the Inspector General of Health, Education, and Welfare or of the Office of Inspector General of Health, Education, and Welfare relating to functions transferred by section 301 of the Department of Education Organization Act [20 U.S.C. 3441];

(E) of the Department of Housing and Urban Development, the office of that department referred to as the "Office of Inspector General";

(F) of the Department of the Interior, the office of that department referred to as the "Office of Audit and Investigation";

(G) of the Department of Labor, the office of that department referred to as the "Office of Special Investigations";

(H) of the Department of Transportation, the offices of that department referred to as the "Office of Investigations and Security" and the "Office of Audit" of the Department, the "Offices of Investigations and Security, Federal Aviation Administration", and "External Audit Divisions, Federal Aviation Administration", the "Investigations Division and the External Audit Division of the Office of Program Review and Investigation, Federal Highway Administration", and the "Office of Program Audits, Urban Mass Transportation Administration";

(I) of the Community Services Administration, the offices of that agency referred to as the "Inspections Division", the "External Audit Division", and the "Internal Audit Division";

(J) of the Environmental Protection Agency, the offices of that agency referred to as the "Office of Audit" and the "Security and Inspection Division";

(K) of the General Services Administration, the offices of that agency referred to as the "Office of Audits" and the "Office of Investigations";

(L) of the National Aeronautics and Space Administration, the offices of that agency referred to as the "Management Audit Office" and the "Office of Inspections and Security";

(M) of the Small Business Administration, the office of that agency referred to as the "Office of Audits and Investigations"; and

(N) of the Veterans' Administration, the offices of that agency referred to as the "Office of Audits" and the "Office of Investigations"; and

(2) such other offices or agencies, or functions, powers, or duties thereof, as the head of the establishment involved may determine are properly related to the functions of the Office and would, if so transferred, further the purposes of this Act,

except that there shall not be transferred to an Inspector General under paragraph (2) program operating responsibilities.

(b) The personnel, assets, liabilities, contracts, property, records, and unexpended balances of appropriations, authorizations, allocations, and other funds employed, held, used, arising from, available or to be made available, of any office or agency the functions, powers, and duties of which are transferred under subsection (a) are hereby transferred to the applicable Office of Inspector General.

(c) Personnel transferred pursuant to subsection (b) shall be transferred in accordance with applicable laws and regulations relating to the transfer of functions except that the classification and compensation of such personnel shall not be reduced for one year after such transfer.

(d) In any case where all the functions, powers, and duties of any office or agency are transferred pursuant to this subsection, such office or agency shall lapse. Any person who, on the effective date of this Act [Oct. 1, 1978], held a position compensated in accordance with the General Schedule, and who, without a break in service, is appointed in an Office of Inspector General to a position having duties comparable to those performed immediately preceding such appointment shall continue to be compensated in the new position at not less than the rate provided for the previous position, for the duration of service in the new position.

(As amended Pub. L. 96-88, title V, § 508(n)(2), Oct. 17, 1979, 93 Stat. 694; Pub. L. 97-252, title XI, § 1117(a)(2), (3), Sept. 8, 1982, 96 Stat. 750.)

AMENDMENTS

1982—Subsec. (a)(1). Pub. L. 97-252 added subpar. (C). Former subpars. (C) to (M) redesignated (D) to (N), respectively.

1979—Subsec. (a)(1). Pub. L. 96-88 redesignated subpars. (C) to (L) as (D) to (M) and added a new subpar. (C).

EFFECTIVE DATE OF 1979 AMENDMENT

Amendment by Pub. L. 96-88, effective May 4, 1980, with specified exceptions, see section 601 of Pub. L. 96-88, set out as an Effective Date note under section 3401 of Title 20, Education.

TRANSFER OF AUDIT PERSONNEL TO INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

Section 1117(e) of Pub. L. 97-252 provided that: "In addition to the positions transferred to the Office of the Inspector General of the Department of Defense, pursuant to the amendments made by subsection (a) of this section [amending sections 2(1), 9(a)(1), and 11(1) of this Act], the Secretary of Defense shall transfer to the Office of Inspector General of the Department of Defense not less than one hundred additional audit positions. The Inspector General of the Department of Defense shall fill such positions with persons trained to perform contract audits."

Remaining technical portions excluded

June 8, 1978
NUMBER 5105.36

ASD(C)

Department of Defense Directive

SUBJECT Defense Contract Audit Agency

References: (a) DoD Directive 5105.36, "Defense Contract Audit Agency," June 9, 1965 (hereby cancelled)
(b) DoD Directive 5000.19, "Policies for the Management and Control of Information Requirements," March 12, 1976

A. PURPOSE

Pursuant to authority vested in the Secretary of Defense under the provisions of title 10, United States Code, this Directive reissues reference (a) and establishes the Defense Contract Audit Agency (hereafter referred to as "DCAA") with responsibilities, functions, authorities, and relationships as outlined below.

B. MISSION

DCAA shall:

1. Perform all necessary contract audit for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all Department of Defense components responsible for procurement and contract administration. These services will be provided in connection with negotiation, administration, and settlement of contracts and subcontracts.

2. Provide contract audit service to other Government agencies as appropriate.

C. ORGANIZATION AND MANAGEMENT

1. DCAA is established as a separate agency of the Department of Defense under the direction, authority and control of the Assistant Secretary of Defense (Comptroller). It shall consist of a Director and such subordinate organizational elements as are established by the Director within resources authorized by the Secretary of Defense.

2. No separate contract audit organization independent of the DCAA shall be established in the Department of Defense.

D. RESPONSIBILITIES AND FUNCTIONS

The Director, DCAA shall:

1. Organize, direct, and manage the DCAA and all resources assigned to the DCAA.

2. Assist in achieving the objective of prudent contracting by providing DoD officials responsible for procurement and contract administration with financial information and advice on proposed or existing contracts and contractors, as appropriate.

3. Audit, examine and/or review contractors' and subcontractors' accounts, records, documents, and other evidence; systems of internal control; accounting, costing, and general business practices and procedures; to the extent and in whatever manner is considered necessary to permit proper performance of the other functions described in 4 through 12 below.

4. Examine reimbursement vouchers received directly from contractors, under cost-type contracts, transmitting those vouchers approved for payment to the cognizant Disbursing Officer and issuing DCAA Form 1, "Notice of Contract Costs Suspended and/or Disapproved," with a copy to the cognizant contracting officer, with respect to costs claimed but not considered allowable. Where the contractor disagrees with a suspension or disallowance action by DCAA, and the difference cannot be resolved, the contractor may appeal in writing to the Administrative Contracting Officer (ACO) who will make his determination in writing. In adddition, the contracting officer may direct the issuance of DCAA Form 1, "Notice of Contract Costs Suspended and/or Disapproved," with respect to any cost which he has reason to believe should be suspended or disapproved.

5. Provide advice and recommendations to procurement and contract administration personnel on:

a. Acceptability of costs incurred under redeterminable, incentive and similar type contracts.

b. Acceptability of incurred costs and estimates of cost to be incurred as represented by contractors incident to the award, negotiation, modification, change, administration, termination, or settlement of contracts.

c. Adequacy of financial or accounting aspects of contract provisions.

d. Adequacy of contractors' accounting and financial management systems, adequacy of contractors' estimating procedures and adequacy of property controls.

6. Assist responsible procurement or contract administration activities in their surveys of the purchasing-procurement systems of major contractors.

7. Direct audit reports to the Government management level having authority and responsibility to take action on the audit findings and recommendations.

8. Cooperate with other appropriate Department of Defense components on reviews, audits, analyses, or inquiries involving contractors' financial position or financial and accounting policies, procedures, or practices.

9. Establish and maintain liaison auditors as appropriate at major procuring and contract administration offices.

10. Review General Accounting Office reports and proposed responses thereto which involve significant contract or contractor activities for the purpose of assuring the validity of appropriate pertinent facts contained therein.

11. In an advisory capacity, attend and participate, as appropriate, in contract negotiation and other meetings which contract cost matters, audit reports, or related financial matters are under consideration.

12. Provide assistance, as requested in the development of procurement policies and regulations.

13. Perform such other functions as the Assistant Secretary of Defense (Comptroller) may from time to time prescribe.

E. AUTHORITY

The Director, DCAA, is specifically delegated authority to:

1. Have free and unrestricted access to and direct communication with all elements of the Department of Defense and other executive departments and agencies as necessary.

2. Establish Defense Contract Audit Agency facilities using appropriate established physical facilities and services of other DoD components whenever practicable to achieve maximum efficiency and economy.

3. Obtain such information, consistent with the policies and criteria of DoD Directive 5000.19, (reference (b)) advice, and assistance from DoD components as he deems necessary.

4. Exercise the administrative authorities contained in enclosure 1 of this Directive.

F. RELATIONSHIPS

1. In the performance of his functions, the Director, DCAA shall:

a. Maintain appropriate liaison with other components of the DoD, other agencies of the Executive Branch, and the General Accounting Office for the exchange of information and programs in the field of assigned responsibilities.

b. Make full use of established facilities in the Office of the Secretary of Defense, other DoD components, and other Governmental agencies rather than unnecessarily duplicating such facilities.

c. The military departments and other DoD components shall provide support, within their respective fields of responsibility, to the Director, DCAA to assist in carrying out the assigned responsibilities and functions of the Agency. Programming, budgeting and financing for such support will be in accordance with policies and procedures prescribed by the Assistant Secretary of Defense (Comptroller).

2. Procurement and contract administration activities of the DoD components shall utilize audit services of the DCAA to the extent appropriate in connection with the negotiation, administration, and settlement of contract payments and prices which are based on cost (incurred or estimated), or on cost analysis.

G. ADMINISTRATION

1. The Director, DCAA, shall be a civilian selected by the Secretary of Defense.

2. The appointment of other personnel to the Agency will be subject to the approval of the Director, DCAA.

3. DCAA will be authorized such personnel, facilities, funds, and other administrative support as the Secretary of Defense deems necessary.

H. EFFECTIVE DATE

This Directive is effective immediately.

CW Duncan Jr.

Deputy Secretary of Defense

Enclosure - 1
Delegations of Authority

DELEGATIONS OF AUTHORITY

Pursuant to the authority vested in the Secretary of Defense, and subject to his direction, authority, and control, and in accordance with DoD policies, directives, and instructions, the Director, DCAA, or, in the absence of the Director the person acting for him, is hereby delegated authority as required in the administration and operation of DCAA to:

1. Exercise the powers vested in the Secretary of Defense by 5 USC 301, 302(b) and 3101 pertaining to the employment, direction and general administration of DCAA civilian personnel.

2. Fix rates of pay for wage board employees exempted from Civil Service classification by 5 USC 5102(c)(7) on the basis of prevailing rates for comparable jobs in the locality where each installation is located.

3. Establish advisory committees and employ part-time advisers pursuant to the provisions of 10 USC 173, 5 USC 3109(b), the Federal Advisory Committee Act, and the Agreement between the Department of Defense (DoD) and the Civil Service Commission on employment of experts and consultants, dated March 14, 1975.

4. Administer oaths of office incident to entrance into the Executive Branch of the Federal Government or any other oath required by law in connection with employment therein, in accordance with the provisions of 5 USC 2903, and designate in writing, as may be necessary, officers and employees of DCAA to perform this function.

5. Establish a DCAA Incentive Awards Board and pay cash awards to, and incur necessary expenses for the honorary recognition of civilian employees of the Government whose suggestions, inventions, superior accomplishments or other personal efforts, including special acts or services, benefit or affect DCAA or its subordinate activities in accordance with the provisions of 5 USC 4503 and Civil Service Regulations.

6. In accordance with the provisions of 5 USC 7532; Executive Order 10450, dated April 27, 1953, as amended; and DoD Directive 5210.7, "Department of Defense Civilian Applicant and Employee Security Program," September 2, 1966:

a. Designate any position in DCAA as a "sensitive" position;

b. Authorize, in case of an emergency, the appointment of a person to a sensitive position in the Agency for a limited period of time for whom a full field investigation or other appropriate investigation, including the National Agency Check, has not been completed; and

c. Authorize the suspension, but not to terminate the services of an employee in the interest of national security in positions within DCAA.

7. Clear DCAA personnel and such other individuals as may be appropriate for access to classified Defense material and information in accordance with the provisions of DoD Directive 5210.8, "Policy on Investigation and Clearance of DoD Personnel for Access to Classified Defense Information," February 15, 1962, and of Executive Order 11652, dated March 8, 1972, as amended.

8. Act as agent for the collection and payment of employment taxes imposed by Chapter 21 of the Internal Revenue Code of 1954 and, as such agent, make all determinations and certifications required or provided for under Section 3122 of the Internal Revenue Code of 1954 and Section 205(p)(1) and (2) of the Social Security Act, as amended (42 USC 405(p)(1) and (2)) with respect to DCAA employees.

9. Authorize and approve overtime work for DCAA civilian officers and employees in accordance with the provisions of the Federal Personnel Manual Supplement 990-1, Section 550.111.

10. Authorize and approve:

a. Travel for DCAA civilian officers and employees in accordance with Joint Travel Regulations, Volume 2, DoD Civilian Personnel;

b. Temporary duty travel only for military personnel assigned or detailed to DCAA in accordance with Joint Travel Regulations, Volume 1, Members of Uniformed Services; and

c. Invitational travel to persons serving without compensation whose consultive, advisory or other highly specialized technical services are required in a capacity that is directly related to, or in connection with DCAA activities, pursuant to the provisions of 5 USC 5703.

11. Approve the expenditure of funds available for travel by military personnel assigned or detailed to DCAA for expenses incident to attendance at meetings of technical, scientific, professional or other similar organizations in such instances where the approval of the Secretary of Defense or his designee is required by law (37 USC 412). This authority cannot be redelegated.

12. Develop, establish and maintain an active and continuing Records Management Program, pursuant to the provisions of Section 506(b) of the Federal Records Act of 1950 (44 USC 3102), the Freedom of Information Act Program (5 USC 552) and the Privacy Act Program (5 USC 552a).

13. Establish and use Imprest Funds for making small purchases of material and services other than personal for DCAA when it is determined more advantageous and consistent with the best interests of the Government, in accordance with the provisions of DoD Instruction 5100.71, "Delegation of Authority and Regulations Relating to Cash Held at Personal Risk Including Imprest Funds," March 5, 1973, and the Joint Regulation of the General Services Administration/Treasury Department/ General Accounting Office, entitled "For Small Purchases Utilizing Imprest Funds."

14. Authorize the publication of advertisements, notices or proposals in newspapers, magazines or other public periodicals as required for the effective administration and operation of DCAA (44 USC 3702).

15 Establish and maintain appropriate Property Accounts for DCAA and appoint Boards of Survey, approve reports of survey, relieve personal liability, and drop accountability for DCAA property contained in the authorized Property Accounts that has been lost, damaged, stolen, destroyed or otherwise rendered unserviceable, in accordance with applicable laws and regulations.

16. Promulgate the necessary security regulations for the protection of property and places under the jurisdiction of the Director, DCAA, pursuant to subsections III.A. and V.B. of DoD Directive 5200.8, "Authority of Military Commanders under the Internal Security Act of 1950 to Issue Security Orders and Regulations for the Protection of Property or Places under Their Command," August 20, 1954.

17. Establish and maintain, for the functions assigned, an appropriate publications system for the promulgation of common supply and service regulations, instructions, and reference documents, and changes thereto, pursuant to the policies and procedures prescribed in DoD Directive 5025.1, "Department of Defense Directive System," November 18, 1977.

18. Enter into support and service agreements with the Military Departments, other DoD agencies, or other Government agencies as required for the effective performance of responsibilities and functions assigned to DCAA.

The Director, Defense Contract Audit Agency, may redelegate these authorities, as appropriate, and in writing, except as otherwise specifically indicated above or as otherwise provided by law or regulation.

This delegation of authorities is effective immediately.

DEPARTMENT OF DEFENSE
DIRECTIVES SYSTEM TRANSMITTAL

NUMBER	DATE	DISTRIBUTION
5105.36, Ch 1	March 17, 1982	5000 series

ATTACHMENTS - None

INSTRUCTIONS FOR RECIPIENTS

The following pen changes to DoD Directive 5105.36, "Defense Contract Audit Agency," June 8, 1978, have been authorized:

PEN CHANGES

Page 2, subsection D.4., line 6. Change the word "allowable" to "reimbursable." Delete the following sentence beginning with "Where the contractor disagrees...." in its entirety.

line 10. Correct second word to read "addition,"

Changes are underscored.

EFFECTIVE DATE

The above changes are effective immediately.

O. J. Williford
O. J. WILLIFORD, Director
Correspondence and Directives

WHEN PRESCRIBED ACTION HAS BEEN TAKEN, THIS TRANSMITTAL SHOULD BE FILED WITH THE BASIC DOCUMENT

SD FORM 1 MAR 68 106-1 PREVIOUS EDITIONS ARE OBSOLETE

Chairman **Roth**. Thank you, Senator Sasser.

I would just like to underscore two or three points that you made. First of all, I agree with you that we have got to look at the basic structure. I am not satisfied with the way it is operating. As a matter of fact, in the conference, when we created the new independent IG, I felt very strongly then and argued, even though I was not a voting member of the conference, that we should have put the post award audit function in the hands of the IG. You are absolutely right, we cannot be satisfied until we have an independent contract audit agency within the Department of Defense that looks upon their job not as getting along with the contractor, but protecting the legitimate interests of the taxpayers.

I shall study your legislation very carefully, and I commend you for your initiative.

Senator **Sasser**. Thank you.

Chairman **Roth**. Senator Bingaman.

OPENING STATEMENT OF SENATOR BINGAMAN

Senator **Bingaman**. Thank you, Mr. Chairman.

Let me just say that this is a problem. I have been on this committee now 1 year and 2 months, and this is a problem that I have heard a great deal about in that time period. I think clearly, there has been enough in the press so that people do want a solution. I think the comments that you have made, Mr. Chairman, and Senator Percy, and the proposal by Senator Sasser to eliminate the agency, I think pretty clearly set out the questions, and the question for me is whether things can be done short of a major restructuring of the audit function in the Department of Defense to solve this problem or whether some type of drastic solution such as Senator Sasser is recommending is essential.

I think independence is essential by whoever has the responsibility to audit. When I was attorney general in my home State of New Mexico, I came to realize very early that you could measure the effectiveness of your prosecution units by the number of complaints you received from the people they were prosecuting.

The auditing function is not quite the same as prosecuting, but I do think that I would feel much more comfortable if we had major complaints being lodged with us by the companies that are the subjects of these audits rather than complaints being lodged from the sources that these complaints are being lodged from.

So I am looking forward very much to the testimony, and I hope we can, from this testimony, come up with a solution to the problem. I am going to seriously consider Senator Sasser's proposal to eliminate the agency. That may be the type of drastic step that is necessary.

Thank you, Mr. Chairman.

Chairman **Roth**. At this time we will hear from the first panel of witnesses, Mr. Sherick and Mr. Starrett. I am going to ask both of you, if you would, to summarize your statements. Your full statements will be included in the record.

I do want to make one comment to you, Mr. Sherick, because you have assumed a heavy responsibility. I am going to look into the reason why Mr. Fitzgerald was not allowed to testify, for there has been, in effect, a coverup. I want to make clear to you, we cannot tolerate the failure of a key witness to appear at the last minute. Now, I have before me an Air Force internal memorandum which says Mr. Fitzgerald's proposed statement apparently reflects his personal perceptions of the issues which he addresses.

I happen to know a little bit more about what went on than maybe they think I do, but I am not going to get involved in that.

I just want you to assume the responsibilities as the independent IG, who was created by the Congress, to go back to the Pentagon and clear this situation up. We are not going to sit here indefinitely and have critical information denied us.

I know what the game is. Anybody that is critical becomes a victim of the Pentagon. Those involved find reasons to eliminate, transfer, or get rid of him. That is not going to be tolerated. The people who are doing a good job should be rewarded. Until we see some recognition being given to those that are trying to do a responsible job, we are not going to be satisfied in this committee.

That is the reason we have these overruns; that is the reason we have these spare parts costing thousands of dollars, because there is a brotherhood over there that won't permit those that are trying to do a job a free hand.

That has got to be stopped, and that is the reason why your office was created.

With that, you may proceed.

Senator **Percy**. I would hope that the Secretary of Defense would encourage people to tell both sides of every issue. We will put our witnesses under oath if there is any doubt about who is responsible for saying what. We have laws protecting whistle blowers.

I have a series of questions I am going to put to you, Mr. Sherick, or someone here, that I intended for Mr. Fitzgerald. I hope you can answer them. But I wish that he were here today to give that testimony.

Chairman **Roth**. Proceed.

Mr. **Sherick**. I will be glad to pass both your concerns to the Secretary and also to look into the background of where the denial was made and at what level. I do know that the Secretary was out of the country, so——

Chairman **Roth**. I am not suggesting that the Secretary was involved. What I want to make clear is that we expect this matter not only to be brought up to the highest channels but more importantly, to be corrected.

Mr. **Sherick**. OK.

TESTIMONY OF JOSEPH SHERICK, INSPECTOR GENERAL, DEPARTMENT OF DEFENSE; AND CHARLES O. STARRETT, DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

Mr. **Sherick**. Mr. Chairman, and members of the committee, I welcome this opportunity to testify today on the contract audit policy and oversight initiatives of my organization.

The Inspector General Act of 1978 as amended requires me to provide policy direction for audits of DOD programs and activities. This includes both internal and contract audits. I am also charged with evaluating the adherence of DOD auditors to internal and contract audit principles, policies, and procedures. To put this responsibility in perspective, I should state that DOD has about 9,400 audit personnel, more than any other Federal department or agency. DOD has 13 internal audit internal review and contract audit organizations. The Defense Contract Audit Agency, with a staff of about 4,000, is the largest.

As concerns DOD contract audit policy, the Department has, over a long period of years, established a series of regulations, policies, procedures, and instructions that establish the ground rules and guidance for the contract auditors of the Department of Defense.

The guidance and standards are takeoffs of those issued by the American Institute of Certified Public Accountants and the Comptroller General of the United States. Because of the extensive policy guidance already in place, I have issued only two additional contract audit policy memoranda to date and have focused my resources on the oversight area.

The primary purpose of my oversight attempts is to monitor and evaluate the adherence of defense auditors to internal audit, contract audit, and internal review standards, policies, and procedures. Oversight reviews are not audits, but, rather, evaluations of the audit organization quality control policies and procedures.

To date, we have issued one final report for our oversight coverage of DCAA. This was a report on the review of audit and other evaluations of major subcontractors pricing proposals.

In this instance, we found that DCAA generally provided timely and quality assistance on subcontractor pricing proposals. However, the overall effectiveness of such audit services could be enhanced if reported deficiencies in cost and pricing data and contractor management systems were reported by DCAA to higher authorities for resolution.

For subsequent oversight reviews, we utilized material developed from a recent case before the Merit Systems Protection Board which identified five areas needing immediate review. These five areas were access to records; reporting of fraud and other illegal acts; reporting of savings resulting from DCAA audits; the relationships between DCAA and DOD criminal investigative organizations, and the independence of DCAA in their dealings with DOD procurement officials and contractors.

The objective of our access to records review was to determine if DCAA auditors were obtaining ready access to contractor data needed for their audits and to evaluate the DCAA policies and procedures for resolving any audit access to records problems.[1] Generally, we found that DCAA field auditors were actively pursuing and generally receiving access to contractor records they needed.

We examined 28 field audit offices and found no significant problems at 15 of them. Access problems, however, were found at 13 of the offices, particularly with respect to the extended delay in resolving access issues.

Two of these 13 field offices had major access problems extending over many years. We concluded that more aggressive action and improved controls were required to insure that DCAA obtained timely access to needed records.

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[1] See p. 522.

We looked at both incurred cost audits and audits of contractor proposals. In our review of access to records for incurred cost audits, which are postaward, we found that contractors denied timely and full access to records needed by the auditor for the effective accomplishment of these audits. One contractor we visited continually denied or restricted DCAA access to basic accounting records. The auditors were denied access to asset, liability, and income accounts in the general ledger and trial balance information.

Data from the work-in-process job cost ledger were given to the auditor verbally, but he was not permitted to verify this data by examining it.

Access to executive payrolls was totally denied, and examination of the general payroll for verification of pay rates was severely limited.

Various restrictions were placed on the interviews of employees for the verification of how labor costs were charged to contracts.

This access to records problem was chronic at this contractor and is a condition that has gone unresolved for many years.

The DCAA's ability to resolve disputes in a satisfactory and timely manner was hindered by the lack of incentive for contractors to provide required records. Typically, when the records were denied, contractors employed delaying tactics such as discussing the need for a record, stating the information was proprietary, stating that the release had to be cleared with another department or manager, and so forth.

This required numerous meetings and wasted efforts on the part of the audit staff. The DCAA operating procedures emphasize that every effort should be made to resolve access disputes at the local level.

These policies provided that the field offices and then the regional office of DCAA must follow elaborate and time consuming procedures to resolve access problems. Only then could consideration be given to more drastic actions such as suspension of payments to contractors.

We recommend, in our report, that the director of DCAA revise agency operating procedures to provide contractors 30 days' notice from the date of the first denial that payments will be suspended if records are not provided. This revision will shift the penalty from the Government to the contractor and provide an incentive for contractors to cooperate in resolving access issues.

We also recommend that copies of all 30-day notices be provided to DCAA headquarters for monitoring and analysis of agencywide access problems.

In our review of audits of contractors' proposals, we found that significant access problems had been encountered by DCAA auditors at three of the 28 contractors included in our review.

For example, a DCAA audit report on a contract proposal for a $3.8 billion multiyear procurement was highly qualified due to denials of access, use of numerous outdated factors by the contractor and limitations on the scope of audit by the requesting procurement activity.

The DCAA audit report on this proposal included five pages of qualifications and concluded that cost or pricing data submitted by the offerer were not adequate for negotiating a contract.

Despite this conclusion, the procurement office negotiated a fixed price incentive contract.

Some of these access problems have existed for decades, not just years. The Department of Defense procurement activities continued to award contracts to these contractors, even though they were aware that DCAA auditors were denied access to contractor documents to which the auditors were legally entitled.

As a result, DCAA's highly qualified reports were of limited, if any, usefulness in the negotiation process. The Department of Defense procurement officials accepted the qualified reports as fulfilling the defense acquisition regulation requirements on audit coverage and proceeded with negotiations of contracts. Thus, the issuance of qualified reports tend to perpetuate rather than resolve the access problem.

I believe a more appropriate course of action is to refuse to perform an audit until, first, the needed records and supporting data are provided by the contractor; second, when DCAA auditors are restricted in the scope of the audit; third, denied access to significant data, or, fourth find data inadequate to support negotiation of a contract.

While DCAA procedures provide for this, we found only one instance where auditors refused to perform the audit. The use of qualified audit reports by DOD procurement officials dilutes the internal control of DCAA in the procurement process.

The DCAA's continued issuance of such highly qualified reports seriously compromises its independence.

We recommend that DCAA take immediate action to resolve the access problem at the two resident offices that had them.

Second, DCAA should issue guidance to its field office not to issue any audit report on any part of the contractor's proposals where denials and/or delays in access to records are encountered, or where supporting data are inadequate for negotiating a contract price.

In our review concerning the reporting of illegal acts, we reviewed the effectiveness and timeliness of DCAA's policies and procedures for reporting and referring to DOD investigative agencies, any suspected contractor fraud or other illegal acts.[1]

We have looked at 60 out of 165 fraud referrals and found that most fraud cases were referred to investigators in a timely manner.

However, we noted extended delays in processing of 20 fraud reports. Although the scope of our review did not include the evaluation of DCAA's procedures, techniques, and training for detecting fraud, we noted that DCAA has increased dramatically the awareness of its auditors to the type of contract fraud.

This increased awareness has undoubtedly contributed to the increase in fraud referrals. During the last 6 months, DCAA referred 59 potential fraud cases to DOD investigators. This is compared with 46 cases for the entire preceding 12 months.

Areas we determined required improvement or change in DCAA's policies and procedures were: communications between the DCAA field auditor and the DOD investigators; controls over the processing of fraud reports received by DCAA headquarters from its regional offices, and discussion of potential fraud cases with DOD procurement officials.

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[1] See p. 558.

Increased communication between DCAA field offices and DOD investigators should contribute to more timely and effective fraud referrals.

The auditor is an expert in accounting matters, and the investigator is an expert in the investigation of fraud. The combination of this expertise is essential for the effective pursuit and investigation of potential fraud cases. The earlier in the process that there is a dialog between the auditor and the investigator, the better the interests of the Government are served. Moreover, DCAA auditors are not necessarily aware of all active investigations by DOD investigators. It is possible that situations will be encountered where DOD investigators have active investigations going on at the same time auditors are identifying fraud in the contract.

Early notification of a suspected fraud could be of significant interest and assistance to the investigators. We recommend in this instance that DCAA implement an agencywide procedures that encourages direct contact between field auditors and DOD field investigators.

In controls over processing fraud cases, we determined that improved controls were needed over the receipt and disposition of fraud reports received by the DCAA headquarters.

We recommended that DCAA establish specific procedures for controlling and monitoring fraud referrals. The procedures should require assigning control numbers to all suspected fraud reports and controlling all related documentation using an assigned number.

Another item of concern involved discussion of potential fraud cases with procurement officials. The DCAA field auditors discussed potential fraud involving DOD procurement officials with local contract administration or procurement officials prior to their referral to criminal investigative agencies.

Premature disclosure of information could hinder or compromise any subsequent investigation by investigative agencies.

We recommended that the director of DCAA issue revised guidance to preclude the discussion of potential fraud cases with the DOD procurement officials unless approval is obtained from the cognizant investigative agency.

We have noted during the course of our reviews some important DCAA actions on the matters I just discussed. With regard to access problems, on February 23, 1984, DCAA issued tougher instructions regarding suspended payments for denial of access. Just recently, DCAA suspended a $6 million payment to a contractor because of access problems. As far as we know, this was the first time payments were suspended for this contractor, and we found only one other contractor in our review whose payments were suspended.

DCAA met with two problem contractors during this period and demanded that they provide access in the future. With regard to fraud referrals, DCAA instituted a fraud referral tracking system at headquarters. It also advised its auditors to clear with criminal investigators any fraud discussions held with persons outside DCAA.

We have several other oversight reviews in process at DCAA right now. These include: a review of defective pricing reports which may involve fraud; sufficiency of audit of small contractors, that is, those who do not have DCAA auditors in residence but are audited on a mobile basis; a review of policies and procedures for DCAA's billings to other Federal agencies, and DCAA's relationship with other inspectors general of those agencies who use DCAA as their audit arm.

We also are looking at the review of operations audits to determine the effectiveness of DCAA's recommendations and corrective action taken by the contractor.

Mr. Chairman, that concludes my formal statement. I am now available for questions.

Chairman ROTH. Mr. Starrett, would you please summarize your statement? Your full statement will be included in the record.

Mr. STARRETT. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I welcome this opportunity to appear before you to discuss the Department of Defense contract audit activities. I am particularly pleased to be able to openly reflect upon the outstanding performance of many of the dedicated professionals in the Defense Contract Audit Agency. I am proud to be associated with this fine organization.

My detailed testimony, which has been submitted for the record, covers those matters identified as being of particular interest to the committee. I will highlight here some of the more important subjects.

DCAA has set all time records in productivity improvements, audit coverage, and taxpayer savings. During fiscal year 1983, the agency realized net savings to the taxpayers of $7 billion through its audit activities. When compared with operating costs of $141 million, this yields $50 in taxpayer savings for each dollar spent and is a 28-percent increase over our 1982 savings ratio of 39 to 1. This level of savings represents a substantial contribution to total audit savings within the Federal Government.

Agency auditors examined over 28,000 contractor pricing proposals worth $235 billion, a dollar increase of 35 percent over 1982. An additional $46 billion in contractor incurred costs claims were audited. New productivity levels were reached in dollars audited per staff hour. At the same time, total costs questioned by DCAA auditors topped $28 billion, an increase of 32 percent over 1982 performances.

Since its formation in 1965, DCAA's mission, as stated in DOD Directive 5105.36 has been: To perform all necessary contract audits for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all Department of Defense components responsible for procurement and contract administration.

DCAA also provides contract audit services to other Government agencies on a reimbursable basis. This service essentially results in the Defense Contract Audit Agency doing all contract audit work at commercial organizations for the Federal Government.

Although this is in itself a broad responsibility, at times we hear criticism that the Agency's focus is too narrow and that we should expand our interrelations with internal audit and investigative components. DCAA's policy is to fully cooperate with the Office of the Inspector General, DOD, and other similar organizations. In fact, DCAA initiated discussions that resulted in a Memorandum of Understanding with the Air Force Office of Special Investigations; the Naval Investigative Service, the Army Criminal Investigations Command and the Office of the Inspector General for Investigations, Defense Criminal Investigative Service. This MOU establishes procedures for requesting contract audit support and describes the procedures by which DCAA will alert investigative organizations of a suspected contractor irregularity.

We have developed for our auditors a self-study course on fraud prevention and detection which reflects the Agency's acceptance of its responsibility to be always alert to the possibility of fraudulent contractor activities. Other executive agencies have requested copies of this course.

Since the establishment of the Defense Procurement Fraud Unit, the Agency has supported its chief, Mr. Richard Sauber, by furnishing headquarters and field auditor assistance for certain DCAA referrals exhibiting a high potential for successful prosecution. This fraud unit has brought order and effectiveness to the pursuit of our referrals, and with its efforts, DCAA has achieved positive results from its program for detecting and reporting suspected fraud and other contractor irregularities. DCAA contract audit disclosures and audit-assisted investigations have enabled the Department of Justice to successfully prosecute a number of contractors for violation of Federal criminal statutes.

Two examples are: A contractor recently pleaded guilty to fraud in Federal court to charges that it filed 25 false claims on Government contracts. It agreed to pay the Government $250,000 in fines and $2,750,000 in civil damages and penalties.

A major defense contractor pleaded guilty to three counts of making false statements in its request for payment on work done for the Department of Defense and agreed to pay the Government $650,000 as double damages, to make an interest payment of $167,000; and to pay a $10,000 criminal fine on each of the three counts for a total of $847,000.

Other examples are included in my detailed testimony. In spite of these accomplishments and our continuing efforts to assure that observations of conditions giving a reasonable basis for suspicion of fraud are referred for investigation, some allegations have been made that we are not doing enough. I am confident that the actions of the Defense Contract Audit Agency have been sufficient from the contract auditing perspective. However, any suggestions for improvement would be certainly given serious consideration.

Another aspect of our auditing practices for which concern has been expressed by this committee is access to contractor records. DCAA's policy regarding access to contractor records may be simply stated: We believe the auditors should expeditiously obtain sufficient competent evidential matter to serve as a reasonable basis for a contract audit opinion. A contractor's denial of access to relevant records should be the subject of swift action to assure that no payments are made to the contractor for costs to which the denied records are relevant.

While our contract audit manual clearly presents this policy, we have recently issued guidance to all our field audit offices that Mr. Sherick discussed in his testimony. This recent issuance reminds our auditors of expected action.

Another subject that has been of interest to this commiteee concerns whether or not the Defense Contract Audit Agency should be part of the DOD IG organization. I have included as an attachment to this statement for the record a memorandum dated February 27, 1984, which addresses this question as it relates to H.R. 4568 of the 98th Congress.[1] The DOD position set forth in that memorandum is that—"The present arrangement protects the necessary independence of DCAA." And goes on to say, "—to integrate the two—the Defense Contract Agency and the IG—in a common organization could adversely impact on the contract audit mission."

Before closing, I invite your attention to the DOD Comptroller's "Report on the Activities of the Defense Contract Audit Agency" for the quarter ended December 31, 1983 which has been submitted for the record as part of my statement.[2] It includes statistical data on productivity for both the quarter and calendar year 1983 along with audit examples and other information which should be of value to this committee in assessing management and operations of Department of Defense audit activities.

I must also point out before closing that the people that are providing the services and the products of the Defense Contract Audit Agency are noticeably absent from this hearing. By that I mean the DOD procurement people that receive and act on our reports and the Department of Justice representatives with whom we work closely on fraud cases. They are not represented. In assessing how well the Defense Contract Audit Agency is accomplishing its assigned mission, I refer the committee to the final report issued by the IG that was discussed in his testimony. That report, No. APO-84-3 says, and I quote, "The Defense Contract Audit Agency generally did an effective job when evaluating prime contractors' pricing proposals."

In another part of the report it says, "The Defense Contract Audit Agency generally provided timely and quality audit services to DOD contracting officers for subcontractors' pricing proposals."

Since the evaluation of pricing proposals is the largest segment of our workload, one can reasonably conclude from this report that DCAA is doing a pretty good job for the taxpayers.

Thank you, again, for this opportunity to appear before the committee. I would be happy to answer any questions.

Chairman ROTH. Mr. Starrett, let me say I am not surprised at your testimony. It is typical of what you have had to say in the past, that all is alright. Let me say I don't have many people on this panel that would agree with that analysis of your agency.

Let me ask you one question: Are you satisfied with the auditing job your organization has done in the case of spare parts? Just a minute, I haven't finished.

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[1] See p. 118.

[2] See p. 121.

Mr. STARRETT. Yes.

Chairman ROTH. I note that even the Secretary of Defense has had some strong words about the inadequacy in this area. Now, I know all about your letter where you say you weren't asked to make an audit. What is your responsibility? Are you not supposed to be an independent auditor that moves forward to protect the taxpayer dollar? Would you answer, please?

Mr. STARRETT. Yes, sir. I can recall many years ago in a hearing where Admiral Rickover was testifying, and at the time, the question was put, about 1966, "Do you think the new Defense Contract Audit Agency is going to be able to do the right job and be tough as far as watching the taxpayers' dollars?" Admiral Rickover's comment at that time was that "I think that the Defense Contract Audit Agency is the agomphious watchdog of the taxpayers dollar."

I thought at the time, my goodness, that's a pretty good compliment. I went back and looked up the word "agomphious." If you go back to a very old dictionary, you will find that word means toothless. I do not think that is so, Mr. Chairman. I believe that the actions of the Defense Contract Audit Agency, as I have included in my statement, clearly indicate that we have been aggressive. We have a number of access to records problems every single day, but by day end, they are usually taken care of.

With regard to spare parts. We have an active program on spare parts now in conjunction with the Secretary's activities in that area. He has a 10-point program. One of those 10 points includes getting the Defense Contract Audit Agency involved in the review of those proposals.

Chairman ROTH. Of course, you are just proving the point that I am trying to raise. You very carefully said "now." The point is, it shouldn't take the Secretary of Defense, it shouldn't take a Secretary of a military service, it shouldn't take a congressional committee to get you to move. This is what you are charged with, and I know of no one that is satisfied with the kind of auditing job that has been done, for example, in the case of spare parts.

But let me move on. We have the testimony of the IG, Mr. Sherick, and the testimony of yourself, and everything is fine, as far as you are concerned. I think that characterizes the problem, frankly, of the Defense Contract Audit Agency and that is that DCAA management is satisfied.

I will agree on one point, that you have got many fine auditors there, but they are going to take their instructions from those who are responsible for their careers, and as long as the Defense Contract Audit Agency feels, as you told my investigators—and they're honest, hard working people; they have been with me a long time—that your relationship with the contractors is of primary importance, I don't think you are going to have the kind of audits we want.

Mr. STARRETT. Mr. Chairman, may I comment on that?

Chairman ROTH. I just want to proceed, and then we will give you your opportunity.

I would just like to compare some of the things which I have heard. For example, you are saying that everything is all right, whereas in Mr. Sherick's statement, he listed any number of situations which are not satisfactory. We found at 13 of 28 field audit offices that there were significant access to records problems. Do you agree that access is important to your job?

Mr. STARRETT. Yes, sir. I agree that access is important. I also agree that at the 13 locations that you are referring to, there were not access problems at the time of Mr. Sherick's review. There were only access problems at two of those locations. I am not saying——

Chairman ROTH. I might say in the case of those two contractors, they were listed by the General Accounting Office as both having access problems for at least 10 years.

We all know that if you don't take strong action when you find that you are denied access that the contractors are never going to pay attention to your requests. Now, Mr. Sherick pointed out in his testimony very clearly that in many cases, your agency issues qualified audits and qualified audits often mean that they did not have adequate access to the information to make the kind of report that is necessary if we are going to be able to negotiate intelligently and prudently with the contractor. Wasn't that part of your testimony, Mr. Sherick?

Mr. SHERICK. Yes, sir.

Chairman ROTH. Would you care to comment on that?

Mr. STARRETT. Yes, sir. With regard to the review of pricing proposals, when a contractor will not provide access to all the needed records, we do not have any contract with that contractor at that time, so therefore, the leverage that has to be used is, you either negotiate with that contractor, or you do not negotiate with that contractor. That is the contracting officer's responsibility. What we provide to the contracting officer is a report that, like Mr. Sherick says, clearly indicates that we did not get the data that we needed to review the proposal.

Chairman ROTH. Let me ask you a question there. How many times in the last 10 years has the Defense Department refused to negotiate when they did not have adequate information?

Mr. STARRETT. I do not know the answer to that question.

Chairman ROTH. Is that information available?

Mr. STARRETT I doubt that it is.

Chairman ROTH. Can you cite any instances of that?

Mr. STARRETT. Oh, yes. I can cite——

Chairman ROTH. What contractor and when?

Mr. STARRETT. Oh, within the last year.

Chairman ROTH. That is not answering my question. I asked with what contractor and when?

Mr. STARRETT. I don't remember the name.

Chairman ROTH. Mr. Starrett, is it one case you remember, two? How many do you remember?

Mr. STARRETT. There are not very many. There are not very many, but it is similar to when you prepare a statement as an auditor on a request for a loan that goes to a bank and the auditor says that the financial condition of this company cannot be determined on the basis of these records. The banker would not make the loan. Now, we are providing that professional advice to the contracting officer, and what we are saying in these reports, as Mr. Sherick says, is that this proposal is not adequate for purposes of negotiation.

Chairman ROTH. Mr. Sherick, as I understand your testimony, part of the problem is that DCAA is going ahead and making qualified audits, and it is your recommendation that they should not proceed because the contractor is apparently ignoring the requirement to supply adequate information.

Mr. SHERICK. That is right. I mean, there are certain basic requirements that we have, and I don't think that we should issue qualified audit reports if the contractor has not met those basic requirements.

I can understand when, as Mr. Starrett says, there are minor discrepancies that can be qualified in the audit report. But where it is a major basis of the contract, I think we should just say no audit report, because what happens is that the minute the contracting officer gets a highly qualified audit report and proceeds to negoitate the contract.

Chairman ROTH. Are you aware of any major case where we have refused to proceed with negotiations where there was an inadequate audit?

Mr. SHERICK. I know of only one case where DCAA has recommended that negotiations be suspended. I don't know of any where we actually did stop negotiating.

Chairman ROTH. Isn't it true that it is going to be a toothless agency until such time as these requirements are taken seriously?

Mr. SHERICK. I feel very strongly that we cannot let contractors just tell us to get lost when we are in there either doing incurred costs contracts or even pricing proposals.

Chairman ROTH. Let me turn a moment to fraud.

Again, I understand, Mr. Starrett, that you feel that your agency is doing an adequate job. If I understand the testimony of Mr. Sherick, the fact is that even though some arrangements were made with the investigative agencies of the Department of Defense, the guidelines have effectively undermined the basic requirements.

Mr. SHERICK. That is right.

Chairman ROTH. Would you care to comment, Mr. Sherick?

Mr. SHERICK. Yes; we feel that the tracking of the report through the process, through the whole structure of the agency, has, in effect, rescinded the MOU in that they don't get quick reports of fraud from the field auditors to the field investigator. I think that Mr. Starrett has taken action to change that. He just recently indicated that there should be quicker and more timely communications between those two, the auditor and the investigator.

Chairman ROTH. My concern, to be perfectly candid, is there are always rules and regulations that read very well, but I am not interested in that. I am interested in what is being done.

I would like to ask you, Mr. Starrett, on how many fraud cases in the last year have you personally recommended that action be taken by the Department of Defense, either to refuse further negotiations until adequate access to information was obtained, or prosecute for fraud?

Mr. STARRETT. If those two are both part of——

Chairman ROTH. Two separate questions?

How many times have you recommended that the Department of Defense refuse to proceed with negotiations because of inadequate information?

Mr. **Starrett**. The one that I mentioned before finally came to me, and that is the only one that I know of within the last year where we have said we are not going to review these proposals any more because the information that we are getting is not——

Chairman **Roth**. Is that a large, medium, or small company?

Mr. **Starrett**. It was a large company.

Chairman **Roth**. What about the company that 10 or 15 years ago, a large company, was cited by GAO as refusing to provide the necessary information?

Are you familiar with that?

Mr. **Starrett**. No, I am not familiar with that one.

Chairman **Roth**. Let me read to you.

On May 10, 1979, the General Accounting Office reviewed DCAA access to budgetary and other cost data supporting contractor price policies.

Mr. **Starrett**. I am familiar with that report, sir.

Chairman **Roth**. In any event, the GAO at that time stated that there were two contractors that refused to provide access to their information and this same comment, as a matter of fact, is made in your report; isn't that correct, Mr. Sherick?

Mr. **Sherick**. Yes. I think, in fact, one of the major contractors we found was the same contractor that had been mentioned earlier by the GAO.

Chairman **Roth**. That is right. Now, has anything been done with respect to that contractor?

Mr. **Sherick**. I understand that DCAA—and Chuck can probably answer it better—has been with them, and they have agreed to rescind any restrictions on access that they had.

Chairman **Roth**. When did that happen?

Mr. **Sherick**. Just recently.

Chairman **Roth**. Could it be a result of some of the inquiries that have currently been made either by you or——

Mr. **Sherick**. I think so. Mr. Starrett is right here. He can answer that.

Chairman **Roth**. Would you care to answer that, Mr. Starrett?

Mr. **Starrett**. Yes, sir. In early December 1983, the IG submitted a questionnaire to the resident auditor at that particular location, and I looked at the results of the answers to that questionnaire.

I got hold of the regional director involved, and I sat down with him, and we decided that these conditions that had been going on for years——

Chairman **Roth**. Why did it take 10, 12 years? I mean, if you were a vigilant auditor, why didn't you move long ago? Why did you have to wait until this was raised by the IG and others 10, 12, 14 years later?

Mr. **Starrett**. I think I need to begin by saying that first of all, I did not mean by my statement, as you have interpreted it to mean, that all is well. We are always looking for ways to improve, and we probably have a lot of ways to improve.

I did not say that all was well.

The actions that Mr. Sherick has talked about are things that we are doing to make sure that we are getting better and better and better.

Chairman Roth. I am raising the question. You were put on notice long ago about this particular contractor.

Mr. Starrett. Yes, sir. I am going to that.

Chairman Roth. And no action was really taken until the IG and others——

Mr. Starrett. That's distorted. That particular contractor has what we refer to in the business as delaying tactics. What I mean by that is that you get denied a record and then a week later, you get it, and that is about the time when you are getting ready to take some serious action, and it goes on and on with delays, and we finally get what we need, but it isn't—we cannot get hold of this situation enough to begin to say that this record is being denied and, therefore, we are going to go into litigation to get that record. As long as the object keeps moving, it is very difficult to get hold of.

But we finally stopped it.

Chairman Roth. In your testimony, you say "a contractor's denial of access to relevant records should be the subject of swift action to be sure that no payments are made to the contractor for costs to which the denied records are relevant."

Have you taken that action at any time?

Mr. Starrett. When I found out about this particular contractor, we took swift action.

Chairman Roth. Did you suspend payment?

Mr. Starrett. We did not have to, sir.

Chairman Roth. Have you ever taken this swift action?

Mr. Starrett. Oh, yes; yes, sir.

Chairman Roth. I would like you to submit a memorandum spelling out those instances.

[The information submitted follows:]

DCAA's policy on access to contractor records as well as guidance on obtaining needed access is set forth in the Contract Audit Manual (CAM) Section 1-206. Your Committee was given a copy of this policy previously. The initial action taken in any problem situation, such as access to a contractor's records or facilities is to discuss the complete issue and courses of action with the contracting officer and responsible contractor officials. If satisfactory access is not gained through this discussion, it is DCAA's policy to take immediate action to assure that the Government's interests are protected. This is done by either an audit recommendation to the contracting officer or by issuing a DCAA Form 1, whichever is appropriate in the circumstances. This has been done on a number of occasions and represents a viable and effective tool to correct unsatisfactory conditions. Through it, we obtain contracting officer support for our position on the access issue and we place the contractor in the position of having to react to obtain payments of related costs on the company's contracts.

We recently reexamined our policy and decided to issue guidance (Memorandum for Regional Directors dated 23 February 1984, previously furnished the Committee) reemphasizing the need to promptly question and/or suspend cost amounts that are determined to be unsupported for lack of access to records. In the case of a pricing proposal review where costs affected by the denial are significant, the need to issue an adverse opinion was reemphasized. An adverse opinion advises the contracting officer that the proposal is unacceptable for negotiation purposes.

We continue to believe that access to records situations must be evaluated by the local field audit office as to the impact of a denial on the auditor's ability to render an audit opinion. In that regard we do not believe that the second action you mention on refusing to issue reports on contractors' pricing proposals is an acceptable "carte blanche" action to resolve access to records issues. The responsibility for resolving such issues rests in the hands of the contracting officer. Withholding issuance of a report would eliminate an effective form of communicating such problems to the contracting officials, and be in violation of our DoD charter requiring us to provide advisory audit services to responsible procurement and contract administration activities. In qualifying a report and questioning or listing the contractor costs as unsupported due to nonaccess to the necessary records, we have established an effective way of advising the contracting officer of the issue and the material effect it has on the contract action involved in the specific report.

The use of the DoD IG subpoena power may become appropriate in certain cases. It is not, however, a panacea to resolve all the issues. As the General Accounting Office experienced in their recent court action on subpoena of records from McDonnell Douglas, it can be a costly and sometimes ineffective process. We believe we can use the current tools we have to adequately resolve access problems we may face. Nonetheless, the IG's subpoena power has not been ruled out as a viable alternative in specific instances where the circumstances warrant it.

Mr. STARRETT. Let me give you an example. Mr. Spanton was having trouble getting access to executive compensation some time ago and we immediately started suspending payments.

Chairman ROTH. We will get into that later. My time is up for the first round.

Senator Sasser.

Senator SASSER. Mr. Chairman, Senator Percy has got to catch an airplane, so I will yield to him for the next round of questioning.

Chairman ROTH. Let me hold you to 10 minutes each.

Senator PERCY. I want to thank my distinguished colleagues very much indeed for their extreme thoughtfulness. We have always worked in a bipartisan way in this committee, and I appreciate that consideration.

Mr. Chairman, before I begin the questioning, could I ask you just one question? We have received a notification from Robert A. Sands, Chief of Contract Pricing and Financial Office, that the testimony of Mr. Fitzgerald may contain statistics which have not been able to be verified. Still, we do have Mr. Fitzgerald's testimony.

Can that be made a part of our record? It has been released by the Department of Defense and made a part of the record. We can keep the record open for a reasonable period so that any rebuttal to that can be made by the Department of Defense. But I think we ought to release this today.

Chairman ROTH. I indicated earlier, Senator Percy, that this report is being released with the understanding it is not the official document of the Department of Defense.

Senator PERCY. All right, fine.

Chairman ROTH. I would just like to point out, I also have a copy of a letter dated February 29 from Mr. Fitzgerald.

Without objection, I will include this letter as part of the record.

[The letter referred to follows:]

DEPARTMENT OF THE AIR FORCE,
Washington, D.C., February 29, 1984.

Hon. WILLIAM V. ROTH, Jr.,
Chairman, Senate Committee on Governmental Affairs, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: At this writing at 11 o'clock, 29 February 1984, I am still working very hard to attempt to get my statement to your Committee on March 1st cleared.

My statement includes positions on important matters which I believe reflect the policy of the Secretary of the Air Force. Therefore, I think it important that I appear in my official capacity, especially since that was the nature of the invitation for me to testify. In fact, the statement I have prepared is not solely my work product. I drafted the statement in conjunction with other officials of our Air Force Secretariat and I have received some comments from the Air Force military staff. I have also attempted to get comments from the Office of the Secretary of Defense. In addition, as noted in the draft comments, the Committee staff was very helpful to me.

The OSD staff may argue that they did not have adequate time to review my statement. However, the main impediment to the completion of my draft report has been OSD and DCAA refusal to furnish me audit work papers on which the Committee staff asked me to comment. Therefore, I do not think that they have legitimate grounds for taking refuge in the short time available for them to review the statement.

I anticipate that I will still be attempting to obtain clearance through the Secretary's office on the morning of March 1. Therefore, I have given copies of this letter to my associates, Mr. Colin Parfitt and Dr. Thomas Amlie, who will be present at the hearings. I have asked them to deliver this letter to you if I am unable to get clearance in time to present my statement as scheduled.

Sincerely,

A. E. FITZGERALD,
Management Systems Deputy.

Senator PERCY. All right. I would like the Department to advise us at what level Mr. Fitzgerald was directed not to appear before this committee in his official capacity.

Did the buck stop at Robert Sands' desk, or did it go higher? I have never had any failure of cooperation from the Secretary of the Air Force or from the Secretary of Defense on any major issue, and I would be very surprised if this matter even got to their desk.

Who did stop him from coming in and testifying in an official capacity at a hearing that we have all scheduled our time to be here for? I don't think there is anyone else that can properly answer those questions, though I will put them to you, Mr. Sherick, or anyone else in the room from the Department of Defense who can answer them.

I would also like to include in the record a copy from a letter from Bruce Newell from the Department of the Navy, which he wrote on behalf of Admiral Watkins and Secretary Lehman, following our hearings on the Navy procurement practices. He stated, in this letter to me, dated May 2 of last year, "you can be confident this type of situation will not be repeated."

I would like to see a letter, properly signed by someone on behalf of the Secretary of the Air Force, indicating that the poor business practices revealed here will be stopped and will be stopped in the Air Force and the Department of Defense.

[The letter referred to follows:]

THE CHIEF OF LEGISLATIVE AFFAIRS,
Washington, D.C., May 2, 1983.

Hon. CHARLES H. PERCY,
U.S. Senate,
Washington, D.C.

DEAR SENATOR PERCY: In response to your letter of 29 April 1983 regarding the Navy's use of funds for habitability, I can assure you that the Chief of Naval Operations and Secretary of the Navy have taken personal interest in habitability expenditures associated with new construction and modernization of the Fleet.

The invoices you cite in your letter are correct. Expenditures of the amount reflected in these invoices are certainly not common practice in outfitting U.S. Navy ships. While there were some unusual circumstances associated with these four ships, which were originally contracted for by the Iranian government, the habitability expenditures reflected are excessive.

As you know, for several months various allegations of fraud, waste, and abuse have surfaced regarding shipbuilding at Ingalls. Each allegation has been thoroughly investigated. In one case, restitution to the Navy has been made by the shipbuilder. When these allegations were first made, action was taken to insure that the regulations regarding construction and outfitting were clearly understood. The specific area of habitability was the subject of a personal message from the Deputy Chief of Naval Operations for Surface Warfare to Surface Ship Type Commanders calling for the continued exercise of "fiscally prudent and judgmentally sound" methods.

In addition, the Chief of Naval Operations has directed the Navy Inspector General, Rear Admiral Henry Mustin, to conduct a specific review of the habitability outfitting of the four KIDD-Class guided missile destroyers. Rear Admiral Mustin is in the process of conducting that review now.

Based on the clearly evident resolve of Admiral Watkins and Secretary Lehman, you can be confident that this type of situation will not be repeated.

Sincerely,

BRUCE NEWELL,
Rear Admiral, U.S. Navy.

Senator PERCY. My first question, Mr. Sherick, is to you. I would like to show you an advertisement that appeared February 26 in the Washington Post. It is designed to catch the eye of defense entrepreneurs.

Do you know what it means by "defense entrepreneur?"

Let me just read a few sentences from this ad.

> If you leave the Government, will you leave friends behind? If so, if you have got friends behind, that means in the Department of Defense. We will set up a division of a national corporation and give you equity as well as a top salary with tax sheltered benefits.

"Curious?" asks the ad, well, I am curious. I wrote a letter to them, sent a copy of it to you yesterday asking who this contractor is.

Is there anyone in the room that knows who this contractor is? Would they care to just stand up and get a little more publicity? [Laughter.] We have got eight television cameras that would give you all kinds of free publicity. [Laughter.] If you would like to have that kind of publicity, is there anyone here who knows about this ad?

[No response.]

Senator PERCY. If not, then, I would just ask you a question. What do you think people had in mind when they placed this ad?

Mr. SHERICK. To me it looks like it is somebody who is putting together a corporation that is going to specialize in lobbying Defense for contracts. What they are interested in is getting people to come work for them who are retired or leaving Defense.

Senator PERCY. Mr. Sherick, from press reports, we are led to believe that in 1981 and 1982, Hughes Aircraft hired roughly 200 high ranking retired officials and Defense civilians. According to Mr. Fitzgerald, few of the Pentagon people are hired for their expertise. What concerns me is that they may be hired and getting paid for services already rendered. I am not so worried about what these officers do once they are hired by a contractor, as I am worried about what they do not do while they're still with the Defense Department and have their eyes on their next job.

Do you share my concern about this revolving door or revolving chair situation?

Mr. **Sherick.** Yes; I do. In fact, I have continuous investigations of that kind of conflict of interest within the Department.

Senator **Percy.** In this room yesterday, I had a hearing for an hour with the Comptroller General of the United States, and pointed out certain areas where there is a lack of liaison with his department and the Justice Department in prosecuting criminals who have been fined who never paid those fines, cheating their government. Crime does pay, we concluded. He said he would get together with the Department of Justice on that and really try to solve it. Let me read from a GAO report, Mr. Sherick, on this situation:

> Department of Justice officials noted that the post employment restrictions have not been enforced through criminal prosecution often because the severity of criminal prosecution was viewed as not in concert with the severity of the particular violations.

People are sometimes sent to jail for possessing 50 dollars' worth of marihuana. We are now talking, according to Mr. Fitzgerald, about billions of dollars of costs to the taxpayers in this revolving door process.

Don't you feel that the Justice Department ought to bear down on this? Would you feel it appropriate for me to provide Mr. Meese some questions at his confirmation hearing as to whether or not we can move forward and do something about this in the Justice Department as well as in internal auditing within the Department of Defense?

Mr. **Sherick.** To my knowledge, we have not had any declinations on conflict of interest. As I say, we do have investigations underway, and I certainly feel that as a deterrent, where you do find this kind of activity, you certainly need to go out there and make an example out of individuals. The revolving door can become a real problem.

Senator **Percy.** Well, it does. I would like to know who drew up this blueprint of this pin? Here is the quotation that was offered, $7,417 for a pin that was given to my staff investigators. Who was doing that? Where is he going to go work, following his 20-year retirement with half pay that people get at age 38, 39, and 40? And they have a lifetime career ahead of them, a lot of them, hundreds of them by the evidence we have got here, right with the contractors that they have been doing business with.

Mr. **Sherick.** I think you are going to find that probably the contractor that designed that weapons system is the one who did the drawing, and he probably also has been the supplier of that item for a long time. That is one of the things that Secretary Weinberger is trying to do now in terms of breakout and in terms of a break in the hold that contractors have on us concerning proprietary items. It is one part of his 10-point program and basically one of the things we are doing.

We probably have the largest DOD audit ever undertaken in the spare parts area. One of the things we are doing is taking hundreds of items like those, and we are going to engineers and asking for the intrinsic value of that piece of material in an attempt to show up this kind of activity.

Senator **Percy**. Mr. Fitzgerald, as Deputy Assistant Secretary of the Air Force, investigated certain charges that our staff revealed, and he came up with similar findings. I would like to ask you just a few questions about those. I do have in my hand copies of timecards from the Hughes plant which I understand have been falsified. Could you explain how this happened, what are the consequences of these alleged abuses for the Defense Department and the taxpayer, and how do these alleged abuses add to the cost of a defense contract?

Mr. **Sherick**. Mischarging, of course, is a major fraud. We have many, many investigations on that underway, and we put people in jail every so often for doing just that. Unfortunately, some of the time we are able to indict and convict a corporation but not pin the actual frauds on individuals.

It is easy with computers, it is very simple to reprogram and move costs. I am not the expert on it—probably Mr. Starrett can give you a much better dissertation on how it is done, but we certainly are very much interested in it. I am interested in it as a fraud.

Senator **Percy**. I ask that the record be kept open so that we could have a detailed explanation as to how it is done.

[The information follows:]

COST MISCHARGING

Cost mischarging is one of the abuses which is common because of the fact that most large Government research and development and production contracts are cost-plus fixed fee contracts. Because the Government reimburses all costs which are allowable, allocable and reasonable, the contractor may increase profit by mischarging. If labor costs are mischarged, they may be multiplied by 100 percent—300 percent in indirect cost allowances. Sometimes a contractor is doing similar work for different agencies on fixed-priced and cost-type contracts. Any work which can be billed to the cost-type contracts will be advantageous to the contractor. Sometimes these costs are shifted into indirect cost pools.

Frequently work that is being done by low-level technicians is billed as being done by senior scientists or engineers at much higher rates. Some work may be billed to several contracts or indirect cost pools. The Government may be billed for the highest cost items by a contractor and these items may be diverted to its commercial work or the contractor may get "discounts" which are not passed on to the Government or which are applied to its commercial accounts.

The issue as to whether a mischarge was a "mistake" or a crime often depends on the issue of intent.

ALLOWABLE COSTS

Under cost type contracts, the Government reimburses the contractor's costs which are allowable, allocable to the contract and reasonable. These types of contracts include cost plus fixed fee, cost plus incentive fee, cost plus award fee, cost reimbursable and cost-sharing contracts. In addition, contract changes and equitable adjustments to contracts are reimbursed on the basis of incurred costs even on fixed price contracts. Cost mischarging occurs whenever the contractor charges the Government for costs which are not allowable, not reasonable, or which cannot be directly or indirectly allocated to the contract.

The DAR 15-205 identifies costs which are allowable and those which cannot be charged to Government contracts. Such costs may be direct costs, such as labor and materials used on one contract and no other, or indirect costs, which contribute to a number of different contracts. Indirect costs are placed in "cost pools" which are then allocated to contracts on some agreed basis (such as total cost or labor hours).

Unallowable costs include:

(1) Advertising costs (except to obtain workers or scarce materials for a contract or to sell surplus or byproduct materials).

(2) Bid and proposal costs in excess of a set limit.

(3) Stock options and some forms of deferred compensation.

(4) Contingencies.

(5) Contributions and donations.

(6) Entertainment costs.

(7) Costs of idle facilities except in limited circumstances.

(8) Idle facilities costs.

(9) Interest.

(10) Losses on other contracts.

(11) Long term leases of property or equipment and leases from related parties are limited to the costs of ownership.

(12) Independent Research and Development costs beyond set limits.

(13) Legal costs related to a contractors unsuccessful defense against charges of contract fraud.

TYPES OF MISCHARGING

The first type of mischarging involves knowingly charging unallowable costs to the Government, concealing or misrepresenting them as allowable costs, or hiding them in accounts (such as office supplies) which are not audited closely. Another common variation involves charging types of costs which have their limits (such as bid and proposal costs or independent research and development costs) to other cost categories.

The second major type of mischarging involves charging costs to the wrong contract or indirect cost pool. Generally, it represents attempts by a contractor with fixed price contracts or commercial contracts to shift labor or materials into Government cost-type contracts. They may shift costs into the direct costs of a Government contract, and these costs may then be multipled by indirect costs and general and administrative expenses or the costs may be charged to indirect cost pools which are charged to Government contracts.

The third major type of mischarging involves charging for work not done. The charges could be for hours or days which were not worked, for the time of "phantom" or nonexistent employees, or for higher wages than were actually paid. The time of technicians, for example, might be charged as that of senior engineers.

A fourth type of mischarging involves charging for materials not used on the contract or charging more than the actual cost of the materials. The excess materials for which the Government is charged may be stolen or diverted or they may not exist. The invoices may be fraudulent and reflect goods not delivered. They also may reflect inflated prices or may not include discounts, kickbacks or other concessions given to the contractor by the supplier. Such concessions may not be reflected on the invoices or in the amounts billed to the Government.

Senator PERCY. Can you tell me something about this HBO receiver and about how receivers like this can be found at the homes of Hughes Aircraft employees? We have heard from some sources that, on company time, charged to the Government, Hughes employees are assembling and making this illegal product and using it in their own homes?

Mr. SHERICK. In the Navy, we used to call it cumshaw, but I don't know what they call it at Hughes. But it is basically poor supervision of the work staff when they have hours available to make that kind of item and that is why the Defense Contract Audit Agency does floor checks. That is what is so important about the ability of the auditors to do floor checks, to get down and find out what people are making, what are they working on, and what are they charging for. We are concerned when contractors deny access to the contract auditors in making floor checks.

Senator **Percy**. Having worked in a multinational corporation for 28 years—having worked on the assembly line, in factory supervision, and ultimately as CEO of that company, I would like you to explain to me—because I can't understand it—how it is possible for employees to tell us how jewelry and other items can be made right on the assembly lines where highly sensitive defense contracting is being done? How is it possible for that to happen in the Hughes plant?

Mr. **Sherick**. I would say it is poor supervision and poor management.

Senator **Percy**. Can you tell me anything about expensive items being ordered and disposed of that Mr. Fitzgerald revealed in his testimony?

Mr. **Sherick**. No. We did a governmentwide audit of Federal equipment in the hands of contractors. In that audit, we found many instances of contractors ordering equipment and supplies that they had ordered in excess of requirements, et cetera. I am not familiar with the incidence that Mr. Fitzgerald mentioned. He certainly hasn't referred it to me, but if we did have the specifics on it, I certainly could open an investigation.

Senator **Percy**. My final question, Mr. Sherick, is can you explain to me why Hughes charged the taxpayers $3,404 per standard work hour for 93 missiles?

Mr. **Sherick**. I can't explain it. I would be very much interested in hearing what Hughes had to say.

Senator **Percy**. I would, too.

Mr. **Sherick**. I would like to get in on that $3,404 an hour. [Laughter.]

Senator **Percy**. Mr. Chairman, inasmuch as Mr. Fitzgerald was not permitted to come today, I understand that we do have sitting in the room Mr. Colin Parfitt, who accompanied Mr. Fitzgerald on his audit of the Hughes Tucson plant. Could I ask him to just give us a one word statement? Mr. Parfitt, having accompanied Mr. Fitzgerald, can you certify that the allegations about illegal HBO receivers and other abuses named in the Fitzgerald testimony are true to the best of your knowledge? And a one word reply would be enough, yes or no.

Mr. **Parfitt**. Yes.

Senator **Percy**. The answer is yes, let it be recorded.

Thank you, Mr. Chairman. I thank my distinguished colleagues very much indeed for their thoughtfulness.

Chairman **Roth**. Senator Sasser, with your permission, Senator Eagleton has an opening statement.

OPENING STATEMENT OF SENATOR EAGLETON

Senator **Eagleton**. Thank you, Mr. Chairman, and I thank my colleague, Senator Sasser. I ask that the full text of my opening statement appear in the record.

Let me just read 2½ minutes thereof. I apologize. I was at another meeting, and I have to return to it.

The Defense Contract Audit Agency has troubled me since about 1978. I have spoken repeatedly about the dangers of having contract auditors who also saw themselves as advisers to contracting officers in part of the contracting process. This has always seemed to me to be an untenable conflict of interest. At different times, I have attempted to transfer the DCAA to the Inspector General or at least to divide the DCAA so that its auditing functions would go to the Inspector General while its contract advice functions would stay in DCAA.

We have not been successful in that effort, although we made an important advance by creating the Inspector General and giving him the authority to hire contract auditors and to review DCAA's function. The value of that step is illustrated today, but the problem that remains inherent in the DCAA's cozy relationship with the defense contractor stands again in sharp relief. Hopefully, this hearing will enable the committee and the Congress to recognize that the creation of the Inspector General was but a first step and not a last step in dealing with the questions of audit and investigation at the Department of Defense.

Finally, I share Senator Roth's anger at the Defense Department's decision to stifle Ernest Fitzgerald from testifying here today. It is particularly ironic and distressing that Secretary Weinberger would choose to react this way with a person whose contribution to public understanding of Defense Department cost overruns is legendary. Unfortunately, this is not the first time that the Defense Department has attempted to kill off the messengers rather than deal with the message.

We should recall that the Pentagon went to great lengths to stifle Chuck Spinney from testifying before Congress with respect to his analysis of the actual cost of the defense budget that the Reagan administration was then proposing. I thank you, Mr. Chairman. I thank Senator Sasser.

[Senator Eagleton's prepared statement follows:]

PREPARED STATEMENT OF SENATOR THOMAS F. EAGLETON

I want to commend Chairman Roth for holding this hearing which is only the latest in an important series of inquiries into the management of the Defense Department. These hearings have illuminated in depth and with care the workings of DOD, with particular emphasis on contracting and acquisition. They have provided the Committee and the Senate with an understanding of how and why the Pentagon suffers from fraud waste and abuse, depriving the taxpayers and the country of the "bang for the buck" to which we should be entitled. The hearings have also given the Committee an important background in these issues needed to enable us to produce legislative reform in the areas of contracting and procurement.

Today's hearing has a special meaning for me. From 1978 to 1982, I argued the case for creation of an independent Inspector General in the Department of Defense. The idea was opposed by the Defense Department, which argued that its audit and investigative operations were perfectly adequate to police the defense budget, and that independence in auditing and investigating was something that was only appropriate for civilian agencies. With the help of Senator Roth and others, we succeeded in prevailing over that view and getting the creation of an independent Inspector General in the Defense Department. The kind of report that Mr. Sherrick delivered today—a frank, no-holds-barred assessment of another agency of the Defense Department—is what we were seeking. The taxpayers and the Congress, and ultimately the Defense Department itself, will benefit from our success.

The Defense Contract Audit Agency has troubled me since 1978. I have spoken repeatedly about the dangers of having contract auditors, who also saw themselves as advisors to contracting officers and part of the contracting process. This has always seemed to me to be an untenable conflict of interest. At different times I have attempted to transfer the DCAA to the Inspector General or to divide the DCAA, so that its auditing functions would go to the IG, while its contract advice functions would stay in DCAA. We have not been successful in that effort, although we made an important advance by creating the IG and giving him the authority to hire contract auditors and review the DCAA's function. The value of that step is illustrated today, but the problem that remains, inherent in the DCAA's cozy relationship with the defense contract, stands again in sharp relief. Hopefully, this hearing will enable the Committee and the Congress to recognize that the creation of the Inspector General was a first step, and not a last step, in dealing with the questions of audit and investigation in the Department of Defense.

Finally, I share Senator Roth's anger at the Defense Department's decision to stifle Ernest Fitzgerald from testifying here today. It is particularly ironic and distressing that Secretary Weinberger would choose to react this way with a person whose contribution to public understanding of Defense Department cost overruns is legendary. Unfortunately, this is not the first time the Defense Department has attempted to kill off the messengers, rather than deal with the message. We should recall that the Pentagon went to great lengths to try to stifle Chuck Spinney from testifying to Congress with respect to his analysis of the actual cost of the defense budget the Reagan Administration was proposing. Evidence of waste, fraud and coverup in the Defense Department do more to undermine support for defense budget increases than anything else I can think of. When will the Department learn that serious problems must be faced, rather than covered up?

Chairman ROTH. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Mr. Sherick, in your testimony, you emphasize the need for the Defense Contract Audit Agency to improve its tracking of fraud reports and fraud cases.

Now, the General Accounting Office fraud hotline has sent the Inspector's General office at DOD nearly 2,000 allegations over the past few years, and your own hotline has processed some 7,000 allegations, your own Department of Defense hotline has processed some 3,000 allegations of fraud, waste, abuse, and mismanagement, as I understand it. How many of those allegations involve the Defense Contract Audit Agency? That is, how many involve allegations of fraud, waste, and mismanagement made by Defense Contract Audit Agency personnel, how many involve reports on which the Defense Contract Audit Agency itself should be taking an action?

Mr. SHERICK. We got about 7,000 allegations during the last 12 months on our hotline, about 2,000 of which are substantive. I can't give you the number off the top of my head, but we do refer some of them to DCAA.

Maybe Mr. Starrett can tell you specifically how many he gets.

Mr. STARRETT. If I understood the question correctly, how many hotline complaints do we get to look into?

Senator SASSER. How many hotline complaints have come into the DCAA hotline that involve allegations of fraud, waste, or mismanagement that are made by DCAA personnel themselves who call the hotline?

Mr. SHERICK. We can't really tell you that, because for one thing, people don't identify themselves when they call our hotline.

Senator SASSER. As I understand it, they have got the option. They can either identify themselves or not identify themselves.

Mr. SHERICK. Yes. That is right. We have control of the hotline. We have control of all allegations, and we can make a run and tell you specifically how many we have got where people identified themselves as members of DCAA.

Senator **Sasser**. I would like to have that information.

Mr. **Sherick**. We know there are some, because we have investigated and indicted and convicted people where we have gotten some.

Senator **Sasser**. I would like to have that information for the record, and I would like to also have the information involving allegations made against DCAA personnel or the agency itself that come in to your DOD fraud hot line.

Mr. **Sherick**. OK.

[The information referred to follows:]

If the individual is willing to provide detailed information, his name, organization or employer, address and phone number where he can be contacted will be recorded in the case file. Only the source's name, together with certain data pertaining to the complaint, will be entered into the computer data base. Retrieval of the names of all the DCAA employees who hve called the Hotline is possible only through means of a manual file search. We are very sensitive to this type of information since the Inspector General Act imposes upon us a duty, after receipt of a compliant on information from any employee, not to disclose the identity of the employee without his consent unless this disclosure is unavoidable during the course of an investigation. We can, through a computer run, determine those complaints which have either been referred to DCAA for aciton or have been made against DCAA. A review of these files has elicited that since 1981 and Hotline has had 19 cases which involved DCAA. Three of the complainants, who gave their identities, were DCAA employees, and confidentiality was extended to three of these individuals at their request. It should be noted that less than one-half of the callers to the Hotline are willing to identify themselves when making a complaint.

Since June 1981, the Hotline has received ten complaints against DCAA.

Senator **Sasser**. Mr. Sherick, it was stated, and I quote:

> If the Defense Contract Audit Agency discovers that a contractor is pursuing a course of action that amounts to fraud against the Department of Defense, DCAA will share that information with the contracting officer, but ordinarily, no contact is made with investigators.

That statement sounds as if it could be lifted out of your testimony here this morning, but I should point out that you will find that statement in the August 1978 report of the Governmental Affairs Committee on the Inspector General Act of 1978. My point is this: If DCAA hasn't changed its modus operandi in 6 years in this area, do you really have any confidence that they are going to change their way of conducting business pursuant to your suggestion today?

Mr. **Sherick**. As I think I mentioned in my statement, one of the things that I commented on as an indicator with DCAA is the fact that in the last 6 months, they have given us more indicators and more notices of fraud than in the entire previous year. Also, as Inspector General, I am running fraud awareness courses for people in the Department of Defense. One of the things that I discovered early on was that there was no overall defense training program that devoted itself strictly to fraud awareness, and we created one. We are out giving it to all our people who are contracting officers, quality assurance people, auditors, et cetera.

DCAA is participating in that training, not only as students, but also as instructors. So I think that they have at least come along in all those areas of fraud. As I say, Chuck can comment on what he has in his own training program along those lines.

Mr. STARRETT. May I comment on the first part of your question, which also talked about how there were instances where we talked to the Government procurement people onsite about fraud?

One of the things that Joe and I are doing right now is to make sure that the facts that he has, that he picked up during his audit agree with the facts as we see them. The three instances that he has are all at one place. Now, there are two parts to the referral of fraud. One is that we get the action accomplished to fix the problem and to give you an example, at one location, there was a spare parts pricing formula that was resulting in overcharges to the Government. We took the action to get that spare parts pricing formula out of existence so that it would not be used any more. We did not advise the local government people that we thought that maybe they were a little too close to the preparation of that formula.

We then subsequently and in different channels referred the matter for investigation. It is true that we did talk to them about the problem, but we did not talk to them about the additional action that we were going to take. Now, that is essentially the case in the other two situations in his report. Our policy in this area is we know whether or not there is a possibility of local people becoming involved in some kind of fraudulent activity. Our policy is and has been that in those cases we will not talk to them until after we have referred it for investigation, and if the investigators say, "Fine, you can talk to them, we don't think they're involved," then we will tell them.

But I hasten to add that those cases are few and far between.

Senator SASSER. My point was that in sharing information of mismanagement or waste or abuse with the contracting officer——

Mr. STARRETT. He is the one that entered into the agreement.

Senator SASSER. But, ordinarily, no contact is made with the investigator. Investigators should get into the thing and make a detailed investigation.

Mr. STARRETT. That isn't the situation, sir, with all due respect.

Senator SASSER. Mr. Sherick, I noted in an advertisement that had been run over your signature that says, "$10,000 reward for disclosure of fraud, waste, and abuse" and then you have your Defense hotline number in this advertisement.

Do you find that this Defense hotline program is working well?

Mr. SHERICK. Yes. We are very happy with the hotline program. We get about 7,000 calls, calls or letters a year. Investigators say that in about one-third of those, there is some substantive basis for the call. We feel that it serves two purposes: One, many of our employees, and you will recall a couple of years ago, there was a questionnaire put out that Federal employees, 70 percent of them saw fraud, waste, and abuse on their job, but very few of them were reported because they were afraid of retaliation.

I think making the hotline, one, available and, two, making it credible gives these people an opportunity to get that information to us, to get it to somebody that does something about it.

In order to make it credible, you have to do something about it, and I have devoted the resources to making the thing work in doing something about it.

The people at the end of my hotline are all criminal investigators. They know how to exploit the information, and I think we do well. We get some good indicators. We get indicators of fraud or waste and mismanagement before they happen. Which is important.

Senator SASSER. So your experience is that the hotline does work?

Mr. SHERICK. Yes.

Senator SASSER. Presently you can only offer $10,000 reward to civilians, or monetary rewards for up $10,000 to civilian employees of the Department of Defense, and you say in your advertisement that efforts are being made to affect changes so that this program of reward for exposing wrongdoing can be made applicable to military personnel, as well.

I would call your attention, Mr. Sherick, to a bill that I have introduced, S. 2119, the Citizens Incentive Awards Act, which will effectively remove the restrictions on participation of military personnel in the cash awards program, and I would solicit the support of the Inspector's General office for that action.

Mr. SHERICK. We have, as part of the President's legislative program, an amendment to the original Schroeder bill to make it available for military personnel, but we certainly would support anything along those lines.

We think it is important.

Senator SASSER. Thank you, Mr. Chairman.

Chairman ROTH. Thank you, Senator Sasser.

Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you, Mr. Chairman.

This morning, we are continuing to blow the whistle ourselves, on the failure of the Defense Department to effectively stop price gouging and abuses by subcontractors. If we are going to succeed in this effort—and it is a major effort with lots of resistance. I know that personally—we are going to have to have information at all levels. There are three kinds of access to information that are at issue this morning:

The first, perhaps, is our access as a committee, to the information that has been stopped by the refusal of someone in the Defense Department to permit Mr. Fitzgerald to testify. So our access has been stymied this morning in the Congress.

Second, there is the IG's access to information at the DCAA. I want to get into that.

The third access that is involved is the DCAA's access to information that is in the possession of the contractor. All three of those have come up in one way or another this morning.

First, Fitzgerald.

Do either of you know or have reason to believe who it is that made the decision that he not testify this morning?

Mr. SHERICK. No.

Mr. STARRETT. Not I.

Mr. SHERICK. I cleared his testimony yesterday.

Chairman ROTH. Mr. Starrett, did you recommend that he not testify or were you involved in any way?

Mr. STARRETT. No, sir, I was not.

Senator LEVIN. Mr. Chairman, do I understand that we are going to be issuing a subpena to get Fitzgerald here?

Chairman ROTH. We have made no decision at this time.

Senator LEVIN. Will we be taking up that issue?

Because I would certainly recommend that we do that.

Chairman ROTH. We have already indicated, Senator Levin, that we are not satisfied and it will not be tolerated.

Senator LEVIN. Do I understand from the chairman—forgive me, I wasn't here earlier—that we have no explanation, Mr. Chairman, from the DOD as to why he was not allowed to testify; is that our understanding?

Has that been put in the record?

Chairman ROTH. The only statement we have, Senator Levin, is that we did ask the IG to give us an explanation on the matter.

Could I yield for one more question, please?

Senator LEVIN. Sure.

Chairman ROTH. Mr. Starrett, your superior, was he at all involved in the decision not to let Mr. Fitzgerald testify?

Mr. STARRETT. I don't know.

Chairman ROTH. You have no knowledge.

Mr. STARRETT. No.

Chairman ROTH. You participated in no way yourself?

Mr. STARRETT. I did not participate in not having—I didn't have anything to do with Mr. Fitzgerald not being able to testify today. I do not agree with his statement. That I can tell you.

Chairman ROTH. Did you advise your superiors on that, you did not agree with the statement?

Mr. STARRETT. Only that I did not agree with the statement.

Chairman ROTH. Who did you so advise?

Mr. STARRETT. I advised my superior, Vince Puritano, Assistant Secretary of Defense, Comptroller.

Chairman ROTH. Thank you.

Senator LEVIN. Did Mr. Puritano indicate what action he was likely to take because you didn't agree with the statement?

Mr. STARRETT. No, he did not.

Senator LEVIN. So you don't believe at all, or have any reason to know or have an inkling to know where this decision came from?

Mr. STARRETT. No, sir. It was a surprise to me this morning.

Senator LEVIN. I am sure this committee is going to stand behind the chairman in the determination that we are going to get Mr. Fitzgerald here. That kind of stonewalling, frankly, contributes to the problem in a major way, and we have seen too much of it. This is the first time it has been so public, but we have seen it in other ways, and I am sure that this committee will stand behind the chairman unanimously to take firm action to make sure that we get any information we want. That is the first kind of information.

The second kind of information is the information which the inspector general has a right to, through the DCAA. Apparently there is some dispute on exactly what information the inspector general can get.

There is a memorandum of a meeting which occurred not too long ago in August 1983 to discuss the dispute as to records that the IG wanted from the DCAA. The quote in that memorandum which was prepared by a member of the IG's office was that the "DCAA was not going to permit the IG to go through a fishing expedition to rummage through DCAA files," and a requirement that the DCAA was going to impose whereby the IG auditors would have to justify their need for access to records.

Mr. Starrett, does the IG have to justify their need for access to your records?

Mr. STARRETT. They do not have to justify access to the records, no.

Senator LEVIN. As far as you are concerned, do they have a right to any record of yours that they want without their justifying their need for it?

Mr. STARRETT. I think that we have worked out an understanding with the IG that adequately protects certain things.

From a practical standpoint, when you are talking legally, I would agree with you, they have access to everything. But with regard from a practical standpoint, I have meetings every now and then with regional directors, and during those meetings, why, we really let our hair down and talk about things that we think are wrong and what it is that we are going to do about them.

Senator LEVIN. My question is, other than the parts, other than records which might be protected by statute, does the IG have access to your records for any purpose they want without justifying it?

Mr. STARRETT. Yes.

Senator LEVIN. Has that always been true?

Mr. STARRETT. Yes.

Senator LEVIN. Mr. Sherick, has it always been true that you have had whatever access you have wanted to their records?

Mr. SHERICK. No, it has not always been true, at least in my experience. When we first started back in the oversight review, we did have problems.

Senator LEVIN. Have those problems been totally resolved?

Mr. SHERICK. I think they have, yes.

Senator LEVIN. As far as you are concerned, you can go on a fishing expedition now if you want?

Mr. SHERICK. I cannot go on a fishing expedition; I don't fish. But I can certainly go get what I need to do my job. No one can qualify my authority to have access to the needed record. If it is compiled in the Defense office with Defense people and Defense money, it belongs to me.

There are certain limitations I have on very sensitive national security areas, but beyond that, if it has a DOD stamp on it, I have access to it, provided that it is a reasonable access.

I don't want my people running out doing a storm trooper act or things like that. They have to use judgment and they have to be responsible.

Senator LEVIN. That is your own internal control.

Mr. SHERICK. That is my own internal control.

Senator **Levin**. I am saying if you want access to documents that are not classified or not protected, as far as you are concerned, you get it?

Mr. **Sherick**. That is right. If it is protected for privacy or something like that, then I respect that protection. But other than that——

Senator **Levin**. Other than any statutory protection such as that, if you want access, you get it; is that your understanding?

Mr. **Sherick**. Yes, that is the way I am.

Senator **Levin**. And you have it now.

Mr. **Sherick**. I have it.

Senator **Levin**. Now, the third kind of access——

Mr. **Sherick**. I might comment, just to clear the air, when I started our audit, first of all, there are many people in not only DCAA, but the whole Department of Defense—who see the Inspector General as a whole new operation.

Everybody over there is very turf conscious as they are throughout the Government. Consequently, as we came into a new area, people challenged our authority, and they question why we wanted to know that.

It usually takes a very short time to let them know what our authority is and to get access.

Senator **Levin**. Thank you.

The third kind of access that I am interested in this morning, at least, is the access that the DCAA doesn't get to contractors. We have testimony later on from Mr. Murphy about a long-standing problem in getting access to the Texas Instruments plant information in Dallas, Tex.

This is part of his testimony, so I make reference to it: "I am personally aware that as early as 1958, the Texas Instruments plant in Dallas was a most difficult contractor from whom to obtain records and data required to accomplish the contract audit mission." He then goes through a history of the difficulties over the years and he indicates that this has been true up to recent times, very recent times, indeed.

Are you familiar with this problem of getting access to information at Texas Instruments, Mr. Starrett?

Mr. **Starrett**. Yes, I am.

Senator **Levin**. Have you recommended that we not continue to do business with them or that we otherwise stop making payments on contracts until we have adequate access?

Mr. **Starrett**. In early December 1983, when this problem was, the seriousness of it came to my attention, we advised Texas Instruments that we were going to withdraw the auditors from that location, if necessary. We were going to stop payments under cost type contracts, if necessary.

Senator **Levin**. What happened following that?

Mr. **Starrett**. We have access. We have broken that problem, I do believe, sir, and I think that we are in good shape now.

Senator **Levin**. Fine, Mr. Sherick, where are recommendations made by the DCAA to the purchasing officer? Is that an inadequate audit?

You only have partial information. We don't have information. Whose responsibility is it to act or not act on that advice?

Mr. SHERICK. The contracting officer has the warrant. He is the agent for the Government, and he decides whether he is going to negotiate or not negotiate with a certain contractor.

Senator LEVIN. Does the DCAA have the right to enforce that advice and to tell the officer to stop negotiating with that company?

Mr. SHERICK. I don't think they can interfere with the contracting officer in his warrant. It has to come down through the chain.

Now, they can certainly call it to the attention of people in the management chain, and that is——

Senator LEVIN. The point I want to make here is that DCAA has the obligation to make the audit, and if they cannot make a full audit, then to make a recommendation of the audit relative to continuing to deal with the company or to make payments on a contract.

But whether or not that is done is up to the contracting officer?

Mr. SHERICK. That is right.

Senator LEVIN. Thus we should have some contracting officers explain why it is.

Mr. SHERICK. Right.

Senator LEVIN. That the DOD continues to do business with companies or to make payments on contracts when companies do not get us information.

Mr. SHERICK. Absolutely.

Senator LEVIN. But what DCAA has to explain is if they don't give you adequate information, as they have explained it this morning, or if they don't make a recommendation to the contracting officer to stop doing business or making payments on contracts; that would be their jurisdiction.

Mr. STARRETT. That is right.

Senator LEVIN. I think what we ought to do is get some additional folks up here to explain why contracting officers continue to do business with companies after having been given a recommendation by the DCAA not to do so or not to make payments on contracts that have been previously entered into.

I just have one additional question, but my time is up, Mr. Chairman.

Chairman ROTH. Go ahead and ask it.

Senator LEVIN. It has to do with the problem of Mr. Spanton who is going to be testifying here later this morning.

Mr. Starrett, I asked you a question back in April 1983, for the record, as to whether or not it wasn't true that it is customary that where someone is ready to retire, as Mr. Spanton was, he has a request for retirement, that one does not apply the usual rotation of 5 years to that person, and your answer for the record did not respond to the question.

So I will ask you the question again this morning.

Is it not true that it is customary when someone is ready to retire and has a request in for retirement that one does not usually apply the usual rotation of 5 years to that person?

Mr. STARRETT. The situation related to Mr. Spanton is currently the subject of a Merit Systems Protection Board hearing, and with your permission, sir, I would have a problem in answering that question now.

Senator LEVIN. My question is a general one, and unless the Chair overrules me here, I am going to ask it. I am not relating the question, now, to Mr. Spanton's particular case.

My question is a generic one, and I repeat it.

Is it not customary that when someone is ready to retire and has a request in for retirement that one does not apply the usual rotation of 5 years to that person?

Mr. STARRETT. The answer to that question is, at remote locations where there is no other place to go to without a permanent change of station and in the absence of other things, other types of problems, yes.

Senator LEVIN. Otherwise, no.

Mr. STARRETT. Otherwise, no.

Senator LEVIN. OK.

Chairman ROTH. Thank you, Senator Levin.

At this time we are going to request that you two gentlemen stay, if you could, until the end of the next panel in case there are any additional questions at that time.

I want to stress two or three points. These are ongoing hearings. I would say to Senator Levin that we do intend to continue with other pertinent witnesses on the matter.

I would like to reinforce to you, Mr. Sherick, that we are looking to you to be the watch dog for the public and the Congress. That was the reason the independent IG was set up, and I know you will agree with me that that puts you in a difficult position. But your job is not, no more than Mr. Starrett's, to get along with your colleagues, but to make sure that the dollar is well spent.

One of the matters I would like to reiterate is that I want to find out why Mr. Fitzgerald was not able to testify here. I intend to insist that he be given the opportunity. We are not going to be satisfied with what appears to be a cover up. That is the only way you can read not letting a responsible public servant who is well known for his service appear at a committee meeting.

I will ask you to investigate that for me, Mr. Sherick.

I am also very much concerned about the subject matter of his statement, that the rates paid to Government contractors, their executives, white collar workers, blue collar workers, all those pay levels. I think it is important that you review these rates in the aerospace industry compared with the private sector that is not involved in such work.

I would like you to discuss that matter with me at a later date. I also understand that you have an additional two reports.

Mr. SHERICK. Yes.

Chairman ROTH. We have seen the draft reports, but we would like to have the final reports as promptly as possible.

Mr. SHERICK. I hope to have them to you within 10 days.

Senator LEVIN. Mr. Chairman, could I ask one additional question?

Mr. Sherick, would you support structural changes in the DCAA?

Mr. SHERICK. Well, yes. I think that DCAA is too decentralized. I think that in an organization as big as DCAA some decentralization is fine, but I think they have gone a little bit too far. Certainly, when an organization deals with as many people as they do and as many different contractors, I think that a stronger central direction is important for positive control even-handedness. Also a much improved management information system that would bring information forward to the director of the DCAA so he knew what was going on.

I think, in many cases, the philosophy in DCAA is to settle problems at the lowest level. When you do that, you leave it up to the individual as far out on the chain as possible to deal or not deal with his problems. It is my own personal opinion that that is not a very good management policy because problems tend to get buried.

Senator Levin. Mr. Chairman, could we leave the record open for some additional questions for both of these witnesses?

Chairman Roth. It will be open for an additional 7 days.

Senator Levin. Thank you.

Chairman Roth. Mr. Starrett, one final question.

How do you respond to allegations by Mr. Spanton and others that DCAA top management has harassed and punished those auditors who are toughest on the contractors?

Mr. Starrett. I deny that.

Chairman Roth. Have you ever given any reward to those who have been tough?

Mr. Starrett. Yes, sir.

Chairman Roth. I would like to have you put that in writing as to who they were.

Mr. Starrett. Yes, sir. I will do that.

[The information referred to follows:]

The Committee's question misstates what the Director said at the 1 March hearing. Senator Roth asked the Director to respond to an allegation that DCAA's top management has harrassed and punished those auditors who are "toughest" on contractors. The Director denied that allegation and at your request agreed to provide information that demonstrates we do reward those who have been "tough."

The Director views "tough" in a much broader sense than the Committee might. The term applies to an auditor who produces work of a high audit quality, uses ingenuity in evaluating contractor operations, takes positive action in resolving problems, and is persuasive in dealing with contractors and acquisition officials. Obtaining the required access to contractor records is only one part of audit performance. In fact a successful resolution of an access problem without other appropriate audit actions does little to enhance audit quality. The real result of good hard-nosed auditing ordinarily takes the form of significant dollar audit accomplishments. The degree to which individual auditors exhibit these characteristics is recognized through DCAA's performance appraisal as well as a variety of awards programs. In calendar year 1983 some 542 audit awards were given. Several examples of these awards for audit accomplishment follow:

Mr. Braulio Delgado, a GS-12 auditor, National Branch Office, received a Quality Salary Increase in September 1983. His in-depth reviews of a contractor's General and Administrative Expenses incurred cost submissions resulted in the following savings on Government contracts: (1) aircraft costs—$580,000, (2) marketing meeting costs—$5,460,000, and (3) 25th anniversary celebration—$701,000.

Mr. Charles Serio, the resident auditor at a major contractor location, was granted a Sustained Superior Accomplishment Award in October 1983 for his overall management efforts. The award was granted, in part, for his aggressive attitude in asserting the Government's right to records and its right to perform operations audits.

Mr. Henry Yamamoto, a GM-13 supervisory auditor at the Peninsula Branch Office, received a Special Accomplishment Award for his highly successful action in obtaining access to financial records previously denied, which ultimately resulted in a significant reduction in the contractor's overhead rate, equating to $100,000 of net audit savings. This was accomplished in spite of contractor protests to the White House and Congress.

Mr. Charles Silverman, a GS-12 auditor assigned to a major contractor location, was awarded a Quality Salary Increase for his efforts on two major proposal audits where more than $15 million of net savings were achieved. He also identified, during a labor review, deficiencies in time card preparation and improper charging practices and convinced the contractor to implement corrective actions.

Mr. Francis Griffith, a GM-13 supervisory auditor at a major contractor location, received a Sustained Superior Accomplishment Award for his personal involvement in the review of the contractor's progress payment system, which disclosed overpayments to subcontractors and overstatements in the allocation of inventory to work in process. He supervised a thorough and detailed review and issued several key audit reports to the contracting officer that explained the complexities of the findings so well that the contractor was directed to deduct a total of $50 million from progress payment requests. An annual cost avoidance amounting to $6 million for imputed interest was realized as a result of changes by the contractor to correct the system deficiencies.

Access to records involving consultant studies and productivity/cost improvements had a major impact on proposal evaluations. Mr. Griffith also played an important role in reviewing the data and devising a reporting mechanism to measure the potential impact on future Government programs. His efforts increased the level of questioned costs on bid proposals from 11.5 percent of dollars examined in MY 1982 to 13.3 percent in MY 1983. At the same time, his individual involvement reduced the average hours per proposal from 177 hours in MY 1982 to 133 hours in MY 1983, or a reduction of 25 percent.

A program which exemplifies the awards process on a field audit office level is the DoD White House Accomplishment Report. Beginning May 1982, a special accomplishment award was created to recognize DCAA field offices making significant contributions to the DoD Monthly White House Accomplishment Report. Through February 1984, 69 different offices received the award—many on multiple occasions. The awards relate to all types of audits and audit issues. While not related specifically to records access, access is certainly an integral part of the audit process. Successful completion, particularly of the more difficult and complex audits, requires resolution of associated documentation issues. For your information we are including as Enclosure 7 the last six months history on those offices recognized (no report was submitted for January 1984).

Recently, this program has been expanded. Each month the leading contributor to the accomplishment report will be selected to receive a letter of recognition from the Assistant Secretary of Defense (Comptroller). Periodically, the most significant contribution will be selected as a basis for distributing individual cash awards. Such incentives stimulate audit efforts and motivate personnel at all levels in the organization to deal with audit issues effectively.

A March 1984 example of individual recognition is an award to Dennis Lesmeister, Minneapolis Branch Office, for his superb auditing skills that led to the investigation and successful prosecution of a major Government contractor charged with improper labor charging. For his efforts he received the recognition of DCAA, the Assistant Secretary of Defense (Comptroller), and a cash award of $2,500.

Chairman ROTH. As I said, you are excused, but I would hope that you might stay just in the event there might be some additional questions after the next panel.

Mr. SHERICK. Thank you.

Mr. STARRETT. Thank you.

[The prepared statements of Mr. Sherick and Mr. Starrett, with attachments, follow:]

STATEMENT BY THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE
HONORABLE JOSEPH H. SHERICK
ON CONTRACT AUDIT POLICY AND OVERSIGHT ACTIVITIES BEFORE THE COMMITTEE ON GOVERNMENTAL AFFAIRS
MARCH 1, 1984

Mr. Chairman and Members of the Committee, I welcome the opportunity to testify today on the contract audit policy and oversight initiatives of my organization. I will cover my assessment of DCAA operations through our recent oversight reviews.

Inspector General Responsibilities

The Inspector General Act of 1978, as amended, requires me to provide policy direction for audits of DoD programs and those relating to fraud, waste and abuse, and program effectiveness. This includes both internal and contract audits. I am also charged with evaluating the adherence of DoD auditors to internal and contract audit principles, policies and procedures.

The Congress provided the Inspector General, DoD with 100 additional positions and made it clear it intended them to be used, in part, to review the work of the DCAA and also to audit entire procurements--the performance of contractors as well as that of defense procurement, supply, audit and program manager personnel.

In FY 1984, my auditors are devoting more attention to procurement matters--over 50 percent of our staff years. We established three new divisions: major acquisition, acquisition support and contract audit. In conjunction with the Military Services and DCAA, we are conducting the largest ever DoD audit on spare parts procurements. About 300 auditors will be examining about 200 contractors that sell spare parts to DoD.

The DoD recognizes the importance of auditing and has about 9,400 audit personnel--more than any other Federal department or agency. The DoD has 13 internal audit, internal review and contract audit organizations, and the DCAA, with a staff of over 4,000, is the largest.

Because of the importance of my audit policy and oversight responsibilities, I established an Assistant Inspector General for Audit Policy and Oversight. That office has two elements--internal audit and contract audit--and a staff of 22 personnel. Although in operation for only about one year, the office has made good progress in implementing its audit policy and oversight responsibilities.

Contract Audit Policy

The DoD has contract auditing policies and procedures set out in directives, instructions and policy memoranda, the Defense Acquisition Regulations, and the DCAA Audit Manual (which has been in existence for many years). Contract auditors must also follow the auditing standards issued by the American Institute of Certified Public Accountants and the Comptroller General of the United States, and policies in Office of Management and Budget Circular A-73.

Because of the extensive policy guidance already in place, we have issued only two additional contract audit policy memoranda to date and have focused our resources in the oversight area. We have been evaluating the adequacy of existing contract audit guidance and examining DoD contract auditor's compliance with it.

Contract Audit Oversight

The primary purpose of oversight reviews is to monitor and evalute the adherence of Defense auditors to internal audit, contract audit and internal review standards, policies and procedures. Oversight reviews are not audits but rather an evaluation of the organization's quality control policies and procedures. The reviews seek to determine whether the quality control policies and procedures are adequately documented, communicated to staff auditors, and effectively complied with so as to provide a reasonable assurance that the audit organizations are meeting the standards of the auditing profession and the needs of the Department of Defense.

To date, we have issued one final report from our oversight coverage of DCAA. That was a report on the "Review of Audits and Other Evaluations of Major Subcontractors Pricing Proposals." We found that DCAA generally provided timely and quality audit assistance to DoD contracting officers for subcontractors' pricing proposals. However, the overall effectiveness of such audit services could be enhanced if reported deficiencies in cost and pricing data and contractor management systems were reported by DCAA to higher authorities for resolution; assist audit reports were included in overall proposal evaluation reports; and the role of DCAA auditors in should cost studies was more clearly defined.

For subsequent oversight reviews, we utilized material developed from a recent case before the Merit Systems Protection Board and identified five areas needing immediate review. These five areas were access to contractors' records, reporting of fraud and other illegal acts, reporting of savings resulting from DCAA audits, relationships between DCAA and DoD criminal investigative organizations, and independence of DCAA in their dealings with DoD procurement officials and contractors.

We issued two draft reports, one on access to contractors' records and another on reporting of fraud. Copies of these reports will be provided to your staff when they are finalized.

Access to Records Review

Our objective in this review was to determine if DCAA auditors were obtaining ready access to contractor data needed for their audits and evaluate the policies and procedures for resolving any access problems. Overall, we found that DCAA field auditors were actively pursuing and generally receiving access to the contractor records they needed. We examined 28 field audit offices and found no significant problems at 15 of them. Access problems were found at 13 of the offices, particularly with respect to extended delays in the resolving access issues. Two of these 13 field offices had major access problems spanning several years. We concluded that more aggressive action and improved controls were required to insure that DCAA obtained timely access to needed records.

- Incurred Cost Audits

We found that contractors denied timely and full access to records needed by DCAA for the effective accomplishment of incurred cost and operations audits. One contractor we visited continually denied or restricted DCAA's access to basic accounting records. The auditors were denied access to asset, liability and income accounts in the general ledger and trial balance. Data from the work-in-process job cost ledger were given to the auditor verbally but he was not permited to verify these data by examining them. Access to executive payrolls was totally denied and examination of the general payroll for verification of pay rates was severely limited. Various restrictions were placed on the interviews of employees (floorchecks) for the verification how labor was charged to contracts. The access to records problems were chronic at this contractor and the condition has gone unresolved for many years.

The DCAA's ability to resolve disputes in a satisfactory and timely manner was hindered by the lack of any incentive for contractors to provide required records. Typically, when the records were denied, contractors employed delay tactics, such as, discussing the need for the records, stating the information was proprietary, stating that release had to be cleared with another department or manager, and so forth. This required numerous meetings and wasted effort on the part of the audit staff.

The DCAA's operating policies emphasize that every effort should be made to resolve access disputes at the "local level." These policies provide that the field offices and then the regional office of DCAA must follow elaborate and time consuming procedures to resolve access problems. Only then could consideration be given to more drastic actions, such as suspension of payments to contractors.

We recommended that the Director, DCAA revise Agency operating policy to provide contractors 30 days notice from the date of first denial that costs (i.e., payments) will be suspended if records are not provided. This revision will shift the penalty from the Government to the contractor and provide an incentive for contractors to cooperate in resolving access issues. We also recommended that copies of all 30-day notices be provided to DCAA Headquarters for monitoring and analyses of Agency-wide denial problems.

- Audits of Contractor's Proposals

Significant access problems have been encountered by DCAA auditors at three of the 28 contractors included in our review. For example, a DCAA audit report on a contractor proposal for a $3.8 billion multiyear procurement was highly qualified due to denials of access, use of numerous outdated pricing factors by the contractor and limitations on the scope of audit by the requesting procurement activity. The DCAA's audit report on this proposal included five pages of qualifications and concluded that cost or pricing data submitted by the offeror were not adequate for negotiating a contract. Despite this conclusion, the procurement office negotiated a fixed-price incentive contract.

Some of these access problems have existed for years. Department of Defense procurement activities continued to award contracts to these contractors even though they were aware that

DCAA was denied access to contractor documents to which the auditors were legally entitled. As a result, DCAA's highly qualified reports were of limited, if any, usefulness in the negotiation process. Department of Defense procurement officials accept the qualified reports as fulfilling the Defense Acquisition Regulation (DAR) requirements on audit coverage, and proceed with the negotiation of contracts. Thus, the issuance of qualified reports tends to perpetuate rather than resolve access problems.

We believe a more appropriate course of action is to refuse to perform an audit until needed records and supporting data are provided by the contractor when DCAA auditors are restricted in the scope of audit, denied access to significant data, or find that data are inadequate to support negotiation of a contract. While DCAA's procedures provide for this, we found only one instance where auditors refused to perform audits. The use of qualified reports by DoD procurement officials dilutes the internal control role of DCAA in the procurement process. The DCAA's continued issuance of such highly qualified reports compromises its independence.

Moreover, the ability of DoD procurement officials to waive the requirement for audits of major contract proposals has weakened the internal control role of DCAA in the procurement process. Prior to 1972, the Armed Services Procurement Regulations (ASPR), Section 3-809(b) stated that the contracting officer shall request an audit review by the contract audit activity. In 1971, the Defense Contract Audit Advisory Council (Malloy Task Group) recommended that ASPR 3-809 (b) be revised to deemphasize the mandatory nature of the requirement for audit review by substituting the words "should normally request" for the words "shall request." The DAR was revised in 1972 to permit the contracting officer to waive the audit requirement for any proposal if other available information is considered adequate to determine the reasonableness of the proposed cost or price. Field audits have been waived or restricted for procurements as high as a billion dollars, despite evidence from prior DCAA reports that significant deficiencies existed in the contractor's estimating and accounting systems and/or proposed costs.

We recommended that DCAA take immediate action to resolve the access problems at the two resident offices that had them. Secondly, DCAA should issue guidance to its field offices not to issue an audit report on any part of a contractor's proposal when denials and/or delays in access to records are encountered or when supporting data are inadequate for negotiating a contract price.

We also recommended that the Under Secretary of Defense for Research and Engineering instruct all acquisition offices to comply with DAR 3-807.5 to withhold awards until contractors provide, during the audit, sufficient cost or pricing data.

Reporting of Fraud or Illegal Acts

We reviewed the effectiveness and timeliness of the DCAA's policies and procedures for reporting and referring to DoD investigative agencies any suspected contractor fraud or other illegal acts. We looked at 60 out of 165 fraud referrals and found that most fraud cases were referred to investigators in a timely manner. However, we noted extended delays in the processing of 20 fraud reports.

Although the scope of our review did not include an evaluation of DCAA's procedures, techniques and training for detecting fraud, we noted that DCAA had increased the awareness of its auditors to the type of contract fraud. This increased awareness has undoubtedly contributed to an increase in fraud referrals. During the last six months, DCAA referred 59 potential fraud cases to DoD investigators, compared with 46 cases for the preceding 12 months.

Areas requiring improvement or change in DCAA's policies and procedures are: (i) communications between DCAA field offices and DoD investigators, (ii) controls over the processing of fraud reports received by DCAA Headquarters from its regional offices, and (iii) discussions of potential fraud cases with DoD procurement officials.

- Communications with Investigators

Increased communication between DCAA field offices and DoD investigators should contribute to more timely and effective fraud referrals. We identified 20 fraud cases where there was a significant delay between initial indication of fraud and referral to DoD investigative agencies. Most of the delays were encountered in the field offices. Our review indicated that some DCAA field auditors were confused on what fraud cases should be reported. Existing DCAA procedures do not provide for communication between DCAA field auditors and DoD investigators until a formal fraud report is prepared. We believe that direct communication as soon as there is an indication of possible fraud would assist DCAA field offices in the timely preparation and processing of fraud referrals.

On May 4, 1983, DCAA and the four DoD criminal investigative agencies signed a Memorandum of Understanding (MOU) on the handling of suspected fraud cases. The MOU provides guidance on the referral of suspected fraud to DoD investigators and for DCAA assistance to DoD investigators in connection with formal criminal investigations.

We believe that implementing guidance issued by DCAA Headquarters in September 1983 has essentially negated the written alert portion of the MOU. According to this guidance, a reasonable basis exists when the DCAA field office has prepared a formal fraud report and the report has been approved by a regional audit manager. Consequently, a written alert is not to be provided until the formal report is ready to be forwarded to DCAA Headquarters for referral to a DoD investigative agency.

The auditor is an expert in accounting matters and the investigator is an expert in the investigation of fraud. The combination of this expertise is essential for the effective pursuit and investigation of potential fraud cases. The earlier in the process that there is dialogue between the auditor and investigator the better the interests of the Government are served. Moreover, DCAA auditors are not aware of all active investigations by DoD investigators. It is possible that situations will be encountered where DoD investigators have active investigations on the same or related areas identified by DCAA auditors. Early notification of the suspected fraud could be of significant interest or assistance to DoD investigators.

We recommended that DCAA implement an Agency-wide policy that encourages direct contact between DCAA field audit office managers and DoD field investigators as soon as auditors have any indication of possible fraudulent acts.

- Controls Over Processing of Fraud Cases

Improved controls were needed over the receipt and disposition of fraud reports received by DCAA Headquarters from its regional offices. We experienced problems in reconciling records of fraud reports maintained by regional offices with information provided by DCAA Headquarters. The DCAA Headquarters could not readily account for all fraud reports submitted by regional offices. The relatively low volume of fraud cases in the past may not have warranted the establishment of a formal records system to account for the receipt and disposition of fraud reports. However, with the increased number of fraud reports, we believe that such a formal system is now needed to insure the timely referral and tracking of fraud reports.

We recommended that DCAA establish specific procedures for controlling and monitoring fraud referrals. The procedures should require assigning control numbers to all suspected fraud reports and controlling all related documentation using the assigned control numbers.

- Discussion of Potential Fraud Cases with DoD Procurement Officials

The DCAA field auditors discussed potential fraud cases involving DoD procurement officials with local contract administration or procurement officials prior to their referral to DoD criminal investigative agencies. Premature disclosure of information could hinder or compromise any subsequent investigation by DoD investigative agencies.

The DCAA requires field auditors to discuss potential fraud cases with procurement representatives or administrative contracting offices and to arrange for any extension in the reporting dates for an audit affected by the conditions. We believe that DCAA personnel should not discuss fraud cases with individuals in other organizations, especially when local DoD procurement officials may be involved, until clearance for such discussions is obtained from DoD investigators.

We recommended that the Director, DCAA issue revised guidance to preclude the discussion of potential fraud cases with DoD procurement officials unless approval is obtained from the cognizant DoD investigative agency.

DCAA Actions on These Matters

We have noted some important DCAA actions on the matters I just discussed.

With regard to access problems:

- On February 23, 1984, DCAA issued tougher instructions regarding suspending payments for denial of access.

- Just recently, DCAA suspended $6 million in payments to a contractor because of access problems. As far as we know, this was the first time payments were suspended for this contractor and we found only one other contractor in our review whose payments were suspended.

- The DCAA met with two problem contractors and these contractors said they would provide access in the future.

With regard to fraud referrals:

- The DCAA instituted a fraud referral tracking system at Headquarters.

- The DCAA advised auditors to clear with criminal investigators any fraud discussions held with persons outside DCAA.

Other Contract Audit Oversight Reviews

We have several other oversight reviews in process at DCAA, including:

o A review of defective pricing reports which may involve fraud. In addition, we will be reviewing the sufficiency of defective pricing audits performed, as well as the DCAA selection criteria.

o Sufficiency of audit of small contractors, i.e., those who do not have DCAA auditors in residence but are audited on a mobile basis. We will be determining whether sufficient minimum audit steps are performed to verify the integrity of contractors' incurred costs.

o A review of policies and procedures for DCAA's billings to other Federal agencies--relations with these agency inspectors general.

o A review of operations audits to determine the effectiveness of DCAA's recommendations and corrective action taken by the contractor. We will concentrate on DCAA's followup on recommendations made to the contractors.

Mr. Chairman, that concludes my formal statement.

PREPARED STATEMENT OF CHARLES O. STARRETT, JR.

Mr. Chairman and members of the Committee, I welcome this opportunity to appear before you to discuss Department of Defense (DoD) contract audit activities. I am particularly pleased to be able to openly reflect upon the outstanding performance of the many dedicated professionals in the Defense Contract Audit Agency (DCAA). I am proud to be associated with this fine organization.

Last year DCAA set all-time records in productivity improvements, audit coverage, and savings for the taxpayers. The day-to-day results of DCAA audit efforts are, for the most part, unknown outside DoD acquisition and audit organizations. In addition, there seems to be a growing misconception about the role of contract audit in the acquisition process. We are exploring alternatives for more public disclosure of DCAA audit activities. In the meantime, I hope that the hearings today will clarify DCAA's contribution to the cause of cost-effective Government procurement.

During 1983 DCAA realized net savings to the taxpayers of approximately $7 billion. When compared to the Agency's operating costs of $141 million, this yields $50 in taxpayer savings for each dollar spent and is a 28 percent increase over our 1982 savings ratio of $39:1. This level of savings represents a substantial contribution to total audit savings within the Federal government. Agency auditors examined 28,000 contractor pricing proposals worth $235 billion, a dollar increase of 35 percent over 1982. An additional $46 billion in contractor incurred cost claims were audited. New productivity levels were reached in dollars audited per staff hour. At the same time total costs questioned by DCAA auditors topped $28 billion, an increase of 32 percent above 1982 performance.

To provide a comprehensive current view of Agency productivity, I am submitting, for the record, the Assistant Secretary of Defense (Comptroller) "Report on the Activities of the Defense Contract Audit Agency for the Quarter Ended 31 December 1983."

In asking me to appear before the Committee, the Chairman requested that I provide information about a wide variety of contract audit matters. I will now provide that information.

DCAA was established on 1 July 1965 by the Secretary of Defense and assigned the responsibility for all DoD contract auditing. Prior to the formation of DCAA, the contract audit function was fragmented among the Army Audit Agency, the Auditor General of the Navy, and the Air Force Auditor General's Office. Then Secretary of Defense Robert McNamara, in announcing the creation of DCAA, stressed the objectives of uniformity and consistency in contract audit activities and the organizational efficiency of a single component providing a common service. In the 18 years since our formation, DCAA has fulfilled those ambitions and more.

The Agency's mission, as stated in DoD Directive 5105.36, has not changed since 1965. It is to:

> Perform all necessary contract audit for the Department of Defense and provide accounting and financial advisory services regarding contracts and subcontracts to all Department of Defense components responsible for procurement and contract administration. . .

We also provide contract audit services to other Government agencies on a reimbursable basis. This service essentially results in DCAA doing almost all the contract audit work at commercial companies for the Federal Government.

While the scope of DCAA's mission has not changed over the years, the amount of responsibility within that mission has grown. Several examples of developments contributing to this growth are:

Cost Accounting Standards Implementation (Public Law 91-379)

Operations Audits

Computer and Other High Technology Audits

Suspected Irregular Conduct Cases

Participation on Should Cost Review Teams

Defective Pricing Audits

The Agency's authorized staffing in 1965 was about 3,600 personnel. Despite the identified areas of increased responsibility as well as the general growth in procurement dollars, DCAA's personnel strength at the outset of FY 1984 stood at 3,750 or a 4 percent growth.

DCAA is a separate agency within DoD under the direction, authority, and control of the Assistant Secretary of Defense (Comptroller).

The Agency relies on decentralized control of audit operations through its six regional offices located in Atlanta, Boston, Chicago, Los Angeles, Philadelphia, and San Francisco. Contract audit policy research and formulation, operational guidance, operational oversight, external liaison, technical training and resource management are provided by the DCAA Headquarters staff located at Cameron Station, Virginia, and by the Defense Contract Audit Institute (DCAI) in Memphis, Tennessee.

The Agency provides audit services world-wide, maintaining some 54 resident audit office locations at major defense contractors, and 73 branch office locations which audit smaller defense contractors numbering around 12,000.

DCAA is separate from and independent of procurement and contract administration. Audit reports and other services provided by DCAA are for the most part advisory and, as such, must be responsive to the needs of procurement. However, audit findings and recommendations are reported objectively and professionally, free from any external restrictions or influences. The scope of audits is determined by the DCAA auditor. There is close coordination with procurement officials as the audit progresses, audit report supplementals are issued where appropriate, and auditor attendance at negotiation conferences is stressed.

All DCAA audit reports not containing classified information are marked "For Official Use Only" and are handled in accordance with implementing regulations on the Freedom of Information Act. The provisions of 18 USC 1905 must also be considered before a report is released to the public.

I have mentioned our historical shortfall in resources before to this Committee. It is appropriate now to acknowledge here the 400 additional audit spaces funded DCAA in the FY 1984 DoD Appropriations Bill. Although hiring patterns indicate that the full impact of these additional resources will not be realized until FY 1985, they will do much to enhance overall audit coverage of defense contracts.

I mentioned the organizational placement of DCAA as being under the supervision and control of the Assistant Secretary of Defense (Comptroller). As such, the Comptroller has the final authority for promulgating operational directives related to DCAA. This Committee has raised questions about the placement of "contract audit policy" and you requested my views on this subject.

The amended Inspector General Act legislation which created a DoD Inspector General does not specifically address "contract audit policy." Since the legislation did exclude DCAA from the Office of the Inspector General, DCAA does not work for the DoD IG. Two points are fairly clear: the IG does have audit policy responsibility for the Department of Defense but does not have any program operating responsibility for contract auditing.

The current controversy over contract audit policy boils down to a definitional problem. The DoD IG has the authority and responsibility for audit policy but when that policy is tailored specifically to DCAA it can quickly become operational guidance. In clearer terms, the DoD IG has substantial direct authority in areas concerning audit standards and has oversight responsibility for DCAA. The DoD IG, however, would not be able to independently provide oversight of DCAA if it also had responsibility for guiding DCAA--a result clearly not envisioned by the amended IG Act.

Although DCAA is a DoD audit organization by definition, it is an operational organization in that it serves as an independent advisor to procurement officials. It is this role as a participant in the operations associated with the acquisition process which led to the Congressional decision to leave DCAA out of the Inspector General organization.

H.R. 4568, a bill "To amend the Inspector General Act of 1978 to transfer the Defense Contract Audit Agency to the Office of the Inspector General of the Department of Defense," was introduced into the 98th Congress. In providing comments on it to the House Committee on Armed Services, the Deputy Secretary of Defense said, "In summary, the present arrangement protects the necessary independence of DCAA and the IG from one another and from the acquisition community without jeopardizing the effectiveness of either the acquisition or audit processes. To integrate the two in a common organization could adversely impact on the contract audit mission. The Department, therefore, recommends against passage of H.R. 4568." A copy of the Deputy Secretary of Defense's letter is submitted for the record.

The following are my comments on selected aspects of DCAA's operations solicited by the Chairman.

FIELD PRICING SUPPORT

The DCAA auditor functions as an independent advisor to the contracting officer during the evaluation and award phase of a procurement. I would like to emphasize several points about our specific role. First, the scope of audit is determined by the auditor. The contracting officer may direct special emphasis in a given area but not limit the scope of audit necessary to render an audit opinion. There are certain rules of thumb on the timeliness of responding to a contracting officer's request for audit assistance. However, due dates for audit reports vary with the complexity and size of the program/proposal being audited as well as factors such as coordination of assist audits, technical evaluations, etc.

Whenever the scope of audit is limited because of time, access to contractor records, outstanding assist audits, lack of a Government technical evaluation, etc., the circumstances of that limitation are clearly explained in the audit report. Further, just as in the public accounting profession, this scope limitation is assessed by the auditor in terms of its impact on the overall audit opinion. When circumstances warrant it, the auditor goes beyond explanations and qualifications and expresses an adverse opinion regarding matters being reported upon.

SPARE PARTS

As with any pricing action, DCAA's involvement in spare parts proposals begins with the request for audit from the contracting officer. This request will generally outline general requirements, note whether technical support has been requested, and identify any areas where special audit advice is desired.

When talking about spares, a distinction must be made between initial spares and replenishment spares procurements. Initial spares generally are bought along with the procurement of the major weapon system. Certain economies of scale accrue when initial spares are bought in this manner. Replenishment spares generally are bought in much smaller quantities on an "as needed" basis to meet logistical requirements. Our experience has been that audit support is generally requested in connection with initial spares and support equipment but not on replenishment spare parts procurement actions. Contracting officers generally have relied on price analysis techniques for those orders. However, conditions have changed, and the number of audit requests involving replenishment spare parts has increased significantly in the last year.

The following is a brief summation of DCAA's recent involvement and the approach taken to assure that DCAA's role in the DoD Spare Parts Procurement Program is effective.

Shortly after Secretary Weinberger issued his memo announcing a ten-point program on spare parts procurement, and the memo identifying specific near-, mid-, and long-term actions to be taken, DCAA issued a directive to all its field audit offices commenting on the Secretary's commitment to act decisively in resolving the spare parts procurement problems, and outlined specific actions to be taken at all major defense contractor locations. Field audit offices were instructed to:

1. Conduct a special overview of spares costing and estimating to identify any glaring weaknesses, including a review of contractor spare parts estimating systems that have not been subjected to a recent review.

2. On a test basis, perform reviews to identify any defective pricing on major spares acquisitions already accomplished.

Point 5 of the Secretary's ten-point program directed DCAA to assist contract administration offices in strengthening spare parts pricing procedures and in the negotiations of major spare parts purchases. It has been DCAA's policy to encourage auditor attendance at negotiations, particularly where audit recommendations contain significant costs questioned. We have reemphasized this policy to the field.

DCAA is currently participating on an assist audit basis with the Assistant Inspector General for Auditing in the DoD-wide audit of spare parts procurement practices directed by Secretary Weinberger. Additionally, DCAA provided audit assistance to the Navy by reviewing the specific circumstances related to spares procurements at Sperry and Gould. The results of these findings will be used in developing new procurement policy.

Over the years DCAA auditors have been alert to observe irregular practices in the pricing of spare parts in both the preaward audits and the postaward defective pricing reviews. For instance, during an audit at Davey Compressor Co., the auditor became aware of certain inflated spare parts prices and advised the Government contracting officer. The contracting officer then requested audits of the small dollar value pricing proposals on hand. Similar irregularities were disclosed and referred by DCAA to the Defense Criminal Investigative Agency for investigation. Davey Compressor recently pleaded guilty to fraud in Federal court to charges that it filed 25 false claims on Government contracts. It agreed to pay the Government $250,000 in fines and $2,750,000 in civil damages and penalties.

SHOULD COST REVIEWS

The Defense Acquisition Regulation defines a should cost review as "a coordinated, in-depth cost analysis" employing "an integrated team of Government procurement, contract administration, audit, and engineering representatives." The purpose of a should cost review is to "(i) identify uneconomical or inefficient practices in the contractor's management and operations and to quantify the findings in terms of their impact on cost," and "(ii) develop a realistic price objective which reflects reasonably achievable economies and efficiencies."

The responsibilities and functions of the DCAA auditor assigned to a should cost team are virtually the same as those encountered in the analysis of individual bid proposals. At a minimum, these functions would include the review of direct labor hours (when based on historical and verifiable cost accounting data), direct labor rates, direct material costs, indirect expense rates, and the adequacy of the contractor's estimating and accounting systems.

Should cost reviews extend the concept of normal pricing proposal reviews by emphasizing the economy and efficiency of the contractor's operations. DCAA has had a long-standing operations audit program to review contractors' economy and efficiency. Therefore, our guidance to our field auditors recommends integrating into the should cost review the results of any previously performed operations audits. This integration means that recommendations contained in DCAA's operations audit reports which are not yet implemented by the contractor should be monetized by the auditor and included in the should cost audit report in order to reflect the impact of the findings on the proposal under review. In this manner, the results of

DCAA's analysis will aid the should cost team in estimating what the proposed contract should cost the Government under efficient and economical conditions.

In addition to integrating previously performed audits, DCAA will perform or aid in the performance of any additional economy and efficiency reviews that are required. Our participation, however, is oriented to the financial aspects. Other should cost team members bring additional skills and expertise to these reviews.

At the present time, DCAA has a formal Memorandum of Understanding (MOU) with the Army regarding our participation on should cost teams. Similar MOUs with the other services are being considered. We support the should cost concept and make every effort to coordinate our normal audit effort with the expanded scope required by should cost.

DEFECTIVE PRICING

In April 1983 I appeared before this Committee and gave testimony concerning DoD's implementation of Public Law 87-653, including DCAA's three-prong program to combat the use of defective contractor cost or pricing data in establishing contract prices. Today I will briefly reiterate the important points of that program as well as highlight a recent enhancement to our audit approach.

DCAA's approach to defective pricing is premised on the belief that it is more advantageous to the procurement system as a whole to correct estimating deficiencies causing defective pricing before they occur instead of performing compliance reviews to detect defective pricing after the contract prices have been established. Deficiencies in cost estimates can arise from the contractor's use of incorrect, incomplete, or noncurrent data. Accordingly, we spend a significant amount of effort in our estimating system surveys and preaward audits to prevent the occurrence of such deficiencies.

Estimating system surveys represent a joint contract audit and contract administration team effort under the leadership of the auditor for the comprehensive review of a contractor's organization, policies, procedures, and practices used to prepare cost estimates and price proposals. The surveys are intended to ascertain the general level of reliability of contractor estimates, identify areas of weakness that may require special emphasis during the review and negotiation of individual pricing proposals, and to recommend improvements necessary to effect corrective action.

Copies of the estimating system survey report are furnished to each purchasing and contract administration office having substantial business with the specific contractor. Last year alone, we expended over 17,000 direct audit hours on this effort and issued approximately 260 survey reports.

A second way in which the Defense Contract Audit Agency attempts to identify deficient estimating techniques causing defective pricing occurs as an integral part of the Agency's program to review and evaluate estimated costs in proposals submitted by contractors in connection with the award, administration, modification, or repricing of Government contracts.

The evaluation of contractor pricing actions is the Agency's highest priority program. Of necessity, a portion of this effort is to determine whether the contractor's estimating techniques used to develop specific bid proposals are both consistent with established policies, procedures, and practices, and appropriate for the proposal under review. Without this determination, the Agency could not satisfy its mission to render an overall opinion on the reasonableness of proposed contract costs. Significant or recurring estimating deficiencies disclosed during proposal reviews are reported to purchasing and contract administration offices in a separate audit report.

While we can quantify the specific findings identified during our reviews and surveys, we also believe that our activities have deterred significant amounts of contract overpricing caused by defective data which we are unable to quantify. I believe that the consistent and continuing application of sound estimating techniques and the development of reliable systems to assure complete and current supporting documentation by contractors is essential to the deterrence of excessive pricing resulting from defective data.

The third part of our program to combat defective pricing concerns the performance of Public Law 87-653 postaward compliance reviews. From its inception, the Agency's compliance program has been accorded a high priority, second only to the review and evaluation of pricing proposals. The primary objectives of our defective pricing compliance reviews are:

1. to ascertain whether individual contractors are in compliance with Public Law 87-653 as it relates to specific pricing actions,
2. to recommend contract price adjustments necessary for Government recovery of contract overpricing caused by defective pricing, and
3. to recommend actions to correct deficient contractor estimating procedures.

Many Department of Defense contractors have literally thousands of contracts subject to the provisions of Public Law 87-653. The Defense Contract Audit Agency is unable to audit all of these contracts for compliance with Public Law 87-653 because of resource limitations and other audit responsibilities.

It is important, therefore, to consider the amount of Government savings resulting from efforts expended on individual Agency mission areas. Our cost comparative analysis showed that our forward pricing program had a Government savings to Agency cost ratio of 132:1 versus a savings to cost ratio for the defective pricing compliance program of approximately 19:1. Obviously, we have to balance our application of resources recognizing these returns. In addition, the performance of our defective pricing program requires a determination of contracts most susceptible to potential defective pricing. This is done by requiring analysis and classification of defense contractors according to the Government's risk of having negotiated contracts based on defective data. For example, a contractor with a poor estimating system or repetitive amounts of large instances of reported defective pricing would be considered a high risk contractor and subjected to close scrutiny in selecting contracts/subcontracts for defective pricing reviews. Beyond that, individual contracts/subcontracts are assessed for their potential for positive defective pricing. It is DCAA's policy and practice to follow up on all potential defective pricing leads and expand our audit efforts in this area where necessary. This includes analysis of not only total cost, but also the individual cost elements comprising the total. The GAO has evaluated DCAA's selection methodology and has not suggested any changes.

In the 16 years in which the Defense Contract Audit Agency has performed defective pricing compliance reviews, we have expended thousands of direct audit hours to complete 19,000 reviews resulting in total recommended price adjustments of $1.1 billion. In the same 16 year period, we have developed and implemented an early warning system for the detection of apparent defective pricing, a matrix of contract pricing actions for contract selection purposes, and a detailed audit program that provides guidance for the efficient and effective accomplishment of defective pricing compliance reviews.

Refinements are continually being made to our program to enhance its effectiveness. As a result, the ratio of positive findings to the number of reviews performed has jumped from 1:7 in 1979 to 1:3 in 1983. Late last year, for example, we issued guidance to our auditors requiring the review of each defective pricing finding to determine whether there was a reasonable basis for suspicion of intentional contract overpricing that could be subject to the penalties of the various fraud statutes. This policy should result in an increasing number of referrals to investigative agencies.

I would also add that both our estimating system reports and defective pricing audit reports are subject to the tracking, reporting, and resolution requirements of Department of Defense Directive No. 7640.2, "Policy for Followup on Contract Audit Reports."

We believe that the Defense Contract Audit Agency's defective pricing compliance program successfully achieves the intent of Public Law 87-653, as interpreted by the Armed Services Board of Contract Appeals and the Court of Claims.

COST ACCOUNTING STANDARDS

The DCAA auditor's basic audit responsibility in the implementation of cost accounting standards is to make recommendations to the Administrative Contracting Officer (ACO) cognizant of an individual contractor as to whether:

- the contractor's disclosure statement adequately describes its actual or proposed accounting practices
- the disclosed practices are in compliance with applicable cost accounting standards and the cost principles contained in Section XV of the Defense Acquisition Regulation

- the failure of a contractor to follow its disclosed practices or to comply with applicable cost accounting standards has resulted in increased costs paid by the Government
- the contractor's proposed price changes submitted as a result of changes made to disclosed accounting practices are fair and reasonable.

The extent to which an individual contractor is subject to the provisions of PL 91-379 varies. Thus the amount of effort strictly identifiable as CAS effort at individual field audit offices also varies. However, I think it is important to understand that the cost accounting concepts embodied in PL 91-379 can be applied at all contractor locations and are used to measure the acceptability of contract cost, incurred or proposed. An evaluation of contractor compliance with CAS is an integral part of all audit activity. Compliance control schedules are maintained as part of permanent audit files. These schedules provide documentation as to whether or not the contractor is subject to and in compliance with the 19 standards promulgated by the late Cost Accounting Standards Board.

When a contractor noncompliance is identified, an audit report is issued to the Administrative Contracting Officer. Where applicable, the noncompliance is also identified in DCAA audit reports on subsequent individual pricing actions. Further action on the resolution of the noncompliance is then governed by the procedures in the Defense Acquisition Regulation Section 3, Part 12. In addition, CAS noncompliance reports are subject to the full provisions of DoDD 7640.2 on audit followup. Throughout the process, DCAA auditors provide whatever followup audit advice is necessary to sustain the audit position. This takes the form of additional technical advice on contractor rebuttals as well as evaluation of the associated cost impact of the noncompliance.

In my testimony before this committee on 19 May 1983, I favored having an organization with authority to monitor and, as appropriate, improve Cost Accounting Standards. No organization has had that authority since the end of fiscal year 1980, when funding for the Cost Accounting Standards Board was terminated. There is a continuing need for that authority to be established.

DCAA'S RELATIONSHIP WITH INTERNAL AUDIT AND INVESTIGATIVE COMPONENTS

DCAA provides professional contract audit services as a part of the acquisition process within DoD and other executive branch departments. Although DCAA is not authorized to independently perform internal audits or to conduct investigations, DCAA contract audit support to investigators and internal auditors is available. DCAA recognizes the importance of the roles of internal auditors and investigators in assuring the effective, efficient, and proper accomplishment of Government procurement and administrative activities, and DCAA is committed to providing timely and appropriate support to all audit organizations.

It is DCAA policy to cooperate fully with all components of the DoD Inspector General and other similar organizations in providing fact-finding assistance. Auditors furnishing audit assistance to an outside organization remain under the operational supervision and control of DCAA management. When internal auditors require verification of contractor data or records at contractors' plants, they request assistance from DCAA. Audit assistance from DCAA concerns contractor operations; internal auditors are responsible for evaluating contracting officer performance.

As an agency, we have been especially sensitive to the role of the contract auditor in reporting suspected fraud and wrongdoing to criminal investigators. Our Contract Audit Manual (CAM) spells out reporting requirements and related audit considerations. The CAM, in outlining our responsibilities, states "although the detection of fraud or similar unlawful activity is not a primary function of contract audit, the auditor must constantly be alert for situations or transactions that may be indicative of such activity." Professional standards (AICPA Statements on Auditing Standards) also require that we exercise due professional care in our examinations.

We have observed that fraud usually occurs where a contractor's control system is deficient or a control breakdown occurs. Therefore, we have emphasized the importance of sound contractor internal controls, adequate audit tests of these controls, and the need for an overall alertness to the possibility of fraud as the best means to disclose and prevent fraud and waste.

Because of the importance of the referral process to the appropriate investigative organization, DCAA initiated discussions that resulted in a Memorandum of Understanding (MOU) with the Air Force Office of Special Investigations (AFOSI), the Naval Investigative Service (NIS), Army Criminal Investigations Command and the Office of Assistant Inspector General for Investigations DoD/Defense Criminal Investigative Service. The MOU serves two purposes:

-Specifies the procedures which will be used by the parties when contract audit support is requested for a criminal investigation into suspected fraud or other suspected irregularity on the part of a Government contractor, grantee, or an official or employee thereof.

-Describes the procedures by which DCAA will alert a DoD investigative organization of a suspected contractor irregularity.

We have issued to our personnel a self study course on fraud prevention and detection which reflects the Agency's acceptance of its responsibility to be always alert to the possibility of fraudulent contractor activities. Our internal publication, the DCAA Bulletin, has frequently included articles which serve to increase the auditor's awareness that successful prosecutions result from proper and expeditious processing of referrals to criminal investigative organizations.

Since the establishment of the Defense Procurement Fraud Unit, the Agency has supported its Chief, Mr. Richard Sauber, by furnishing Headquarters and field auditor assistance for certain DCAA referrals exhibiting a high potential for a successful prosecution. This Fraud Unit has brought order and effectiveness to the pursuit of our referrals and with its efforts DCAA has achieved positive results from its program for detecting and reporting suspected fraud and other contractor irregularities. As a result of contract audit disclosures and audit-assisted investigations, the Department of Justice successfully prosecuted a number of contractors for violation of Federal criminal statutes.

Examples are:

1. A company and two of its vice-presidents were convicted in a Federal district court on charges of conspiring to defraud the Government and making false statements to the Government. The company pleaded guilty to a 100-count criminal indictment; the two vice-presidents pleaded guilty to two counts. The company was fined $706,000, and the individuals $20,000 each and given six-month suspended sentences. The company also agreed to an administrative recovery of improperly charged costs amounting to approximately $1.5 million.

2. A company was fined $200,000 on charges that it submitted false claims for payment under a contract with the Government. The company also agreed to pay $850,000 to settle all Government claims arising from the Federal investigation, and agreed not to charge Government contracts for a portion of the legal fees incurred during the investigation, amounting to a Government savings of $250,000.

3. A defense contractor's president and a former president pleaded guilty to defrauding the Government. In a plea bargaining agreement, the corporation will repay $750,000 to the Government because it submitted false public vouchers which fraudulently inflated the hours charged to an Army contract. The Government will withhold an additional $260,000 representing adjustments on other contracts. The officials face possible prison terms plus fines up to $10,000. The contractor also faces a $10,000 fine.

4. After a seven-week trial in a US District Court, the president and chief executive officer of a company were found guilty of conspiracy to defraud the Government, filing false claims, and shipping defective

merchandise to the Government under Department of Defense contracts. The vice-president of the company was found guilty during the same trial of perjury before the federal grand jury which investigated the fraud. The president was sentenced to six months in prison, two years probation, and fined $55,000. The vice-president was sentenced to two years probation and fined $2,000.

5. A major defense contractor pleaded guilty to three counts of making false statements in its requests for payment on work done for the Department of Defense and agreed to pay the Government $650,000 as double damages, to make an interest payment of $167,000 and to pay a $10,000 criminal fine on each of the three counts for a total of $847,000.

6. Another major company signed a consent decree after the Justice Department alleged that the company fraudulently mischarged costs on its space shuttle contract. The contractor didn't admit or deny guilt in signing the consent decree, but agreed under its terms to pay the Government $500,000 in compensatory damages and to spend $1 million toward the cost of installing a computerized time-keeping system to prevent future abuses.

7. A consulting firm pleaded guilty in Federal court to illegally inflating pay vouchers on Government contracts and agreed to pay $30,000 in fines and a $40,000 civil penalty.

8. In a very recent case, a complaint was issued by the US District Court, Northern District of California, alleging that a company made false claims when it overstated cost/pricing data on ten separate defense procurement contracts. The Government is asking either double damages totalling $1,540,884 and a fine of $22,000, plus costs of the suit; or actual damages of $770,442 and punitive damages of $1.5 million.

ACCESS TO CONTRACTOR RECORDS

The third standard of field work promulgated by the American Institute of Certified Public Accountants (AICPA) states, "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination." DCAA's contract auditing and reporting standards directly incorporate this AICPA standard, which provides the audit basis for requiring access to a contractor's books, records, facilities, employees, etc. The contractual provision establishing the auditor's right of access to contractor data is contained in DAR 7-104.41(a). This clause is also supported by law.

Over the years there have been disagreements with contractors over what records or other access are required to be provided the auditor. Such disagreements are inherent to the audit process. Actions by companies to limit audit access to records is not a condition unique to DCAA. The IRS, GAO, and many Inspector General activities often encounter similar problems.

DCAA's policy regarding access to records may be simply stated. We believe the auditor should expeditiously obtain sufficient competent evidential matter to serve as a reasonable basis for a contract audit opinion. A contractor's denial of access to relevant records should be the subject of swift action to assure that no payments are made to the contractor for costs to which the denied records are relevant.

While our Contract Audit Manual clearly presents this policy, we have recently issued guidance to all of our field offices reminding them of the expected action.

DCAA POLICIES REGARDING AUDITOR ROTATION

The Agency's mandatory rotation policy was established in 1967 and initially set a maximum tour of duty of five years for GS-13 and -14 resident auditors who are responsible for managing DCAA field audit offices located in defense contractor facilities. Over the years, the rotation program has been expanded to include other auditor positions such as procurement liaison auditors, Defense Contract Audit Institute instructors and other staff members, and Headquarters program managers. As it now stands, almost every DCAA auditor at the GS/GM-13-15 and Senior Executive Service grade levels is subject to a maximum tour of duty of five to seven years. Principally, the rotation policy was established to cover supervisory and managerial personnel because it is at those levels that the individual auditor has a high degree of influence over the results of audits.

Within the public accounting profession, there is an expressed understanding that independence, in fact and in appearance, is required of auditors. The American Institute of Certified Public Accountants (AICPA) specifically addresses independence in its second general standard wherein it states: "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors."

The Comptroller General of the United States has also issued "Standards for Audit of Government Organizations, Programs, Activities and Functions" which includes the precept: "In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be free from personal or external impairments to independence, must be organizationally independent, and shall maintain an independent attitude and appearance."

Within DCAA, we have recognized that long associations by individual auditors with the same contractor can lead to the auditor's predisposition to the status quo; laxity in his or her work when the same systems, records and controls are reviewed year after year, and less inspired efforts and critical inquiries than are often seen in the early years of an audit engagement. In short, because of these inherently human tendencies, truly independent action by the auditor becomes difficult and a certain tolerance develops with the passage of time. Even when these characteristics do not exist, the "appearance" of indepandence is questionable. Accordingly, since we know of no other management method for overcoming these influences, the only means DCAA has to ensure auditor independence and high quality performance is through mandatory auditor rotation.

The DCAA rotation program also supports the Agency's need for the continuing development of its auditor work force. The planned movement of auditors is important to effective career management and the achievement of personnel staffing requirements. Auditors, especially audit supervisors and managers, need diverse audit experience to enable them to cope with the variety of circumstances they encounter as their responsibilities become greater. Equally important, the program also has value to the Agency by permitting the disposition of its personnel resources in a more efficient manner by providing for the greater sharing of organizational talent, especially in those less desirable assignments or geographic locations.

FACTORS USED IN APPRAISING AND EVALUATING THE PERFORMANCE OF DCAA AUDITORS

Organizational objectives provide the general framework for identifying personal goals and responsibilities for each auditor. DCAA has issued standardized critical performance elements for all auditor positions, Agency-wide. These elements represent capsulized aspects of the most important duties and responsibilities associated with auditor work at each grade level. For example, the critical performance elements for a GM-13 supervisory auditor include: (1) audit planning and programming; (2) audit supervision and performance; (3) relationship with procurement and contractor representatives; (4) staff management and career enhancement; and (5) equal employment opportunity. Critical performance elements for a GS-12 full performance auditor (nonsupervisory) include (1) audit program preparation, revision and execution; (2) timeliness and quality of audit performance and audit reports; (3) responsibility for performing independently; and (4) maintaining effective working relationships with acquisition and contractor representatives. The individual auditor's performance is appraised in relation to these objectives.

The principal objective of the DCAA performance appraisal process is to link the individual auditor's performance to organizational goals. This is accomplished by translating the Agency's goals into specific work unit objectives, program activities and individual performance requirements at every organizational level. Each auditor is then appraised on an annual basis by comparing actual performance with the previously established personal work goals. During the course of the annual evaluation cycle, supervisors accumulate and record documentary information, statistical data, and other significant observations of their subordinates' output and manner of performance. At the end of the appraisal period, the compiled performance data is translated into an assessment of the degree to which each individual objective was met based on the factual and statistical data accumulated. Four levels of achievement are possible: Viz, far exceeds standard, exceeds standard, satisfies standard, and does not satisfy standard. A mechanical synthesis of the ratings for the individual performance elements is used to derive one of the following five performance summary ratings: Outstanding, superior, fully satisfactory, minimally satisfactory, and unsatisfactory.

I am aware that the Committee has raised some concern about evaluating DCAA auditors on whether they have an effective working relationship with contractor representatives. Too much should not be read into this. At locations where contractors are difficult to deal with, an auditor could get an outstanding rating in this category even if almost every audit recommendation is contested by the contractor. In such a case, the auditor's supervisor will be closely involved. The auditor's evaluation will be based on whether he or she has acted in a competent and professional manner throughout the period. Unprofessional conduct, such as frivolous recommendations, would create needless barriers that result in inefficient use of audit resources. The auditor's supervisor would be expected to correct that type of situation.

Thank you - I hope I have adequately addressed your questions.

THE SECRETARY OF DEFENSE
WASHINGTON, THE DISTRICT OF COLUMBIA

27 FEB 1984

Honorable Melvin Price
Chairman, Committee on Armed Services
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Reference is made to your request for the views of the Department of Defense on H.R. 4568, 98th Congress, a bill "To amend the Inspector General Act of 1978 to transfer the Defense Contract Audit Agency to the Office of the Inspector General of the Department of Defense."

The Defense Contract Audit Agency (DCAA) is currently a separate agency within the Department of Defense reporting through the Assistant Secretary of Defense (Comptroller) to the Secretary of Defense. The proposed bill would alter this arrangement by abolishing the DCAA as a separate DoD agency and transferring its functions, personnel, and associated resources to the Office of the Inspector General.

The Department of Defense opposes enactment of this legislation. The mission and functions of DCAA are different in substance and orientation from those assigned to the Inspector General of the Department of Defense under the Inspector General Act of 1978, as amended. DCAA performs DoD-wide audits of contracts subsequent to their award by DoD procurement and contracting officials, and also provides accounting and financial advisory services regarding contracts and subcontracts to all DoD components exercising responsibility for contract negotiation and procurement management. These services are also provided to the DoD Inspector General and other internal audit agencies as well as to other federal agencies and foreign governments.

The audits of contracts subsequent to award is an extension of, and for practical purposes, not separable from DCAA's preaward work. In carrying out these functions, which constitute a substantial qualitative and quantitative portion of the agency's workload, DCAA engages in extensive consultation with contracting officials in reviewing and evaluating contract proposals and monitoring contract execution. In so doing, it provides an essential service integral to the effective accomplishment of the DoD procurement process. DCAA is not, therefore, strictly a staff level review and oversight organization engaged in "after the fact" audits. It is also an active technical consultant in the acquisition process and, as such, serves as an independent advisor to contracting officers.

This unique and distinct nature of DCAA has long been acknowledged by the Congress. A report by the House Committee on Government Operations, for example, has noted that:

> The concept which guides the DCAA, it is plain, makes Defense contract auditing integral to the procurement process. DCAA auditors are part of the procurement team; they sit, when needed, at the elbow of the contracting officer, advising, recommending, supplying relevant data extracted from contractors' books and records. A large part of the auditing work is done before or during contract negotiations. The objective is making a good contract for the Government (H.R. Rep. No. 1132, 90th Cong. 2d Sess. 4 (1968)).

This same understanding was exhibited by the Congress in the decision to exempt DCAA from inclusion in the Office of the Inspector General of the DoD when that organization was originally established. Instead, it provided the Office of the Inspector General with its own contract audit capability for the purposes of (1) overseeing and reviewing the work of DCAA, and (2) reviewing entire procurements when such action is deemed necessary. The Congress also provided the Inspector General with responsibility to develop audit policy and evaluate program performance for all DoD audit organizations, including the DCAA. However, the provision of advice to Defense contracting officials in the process of negotiating contracts was specifically excluded from the Inspector General's purview (H.R. Rep. No. 97-749, 97th Cong. 2d Sess. 176-177 (1982)). The Department of Defense shares this sensitivity for the difference between internal audit functions, which are properly the domain of an Inspector General, and those of DCAA. The Department of Defense endorses continuation of the current arrangement, an arrangement which, it should be noted, was purposefully arrived at by the Congress after considerable deliberation. DCAA is an independent, but essential, component of the procurement process. It should be kept separate from the Inspector General's organization to allow that group to conduct independently internal audit and program performance reviews of DCAA.

Fundamental audit policy dictates that operations be separated from the organization auditing them. Therefore, the IG should have no operational responsibility. DCAA auditors, on the other hand, have such responsibility in the acquisition process, as advisors to the contracting officers. DCAA's independence from them, in turn, is assured by its separate organization and its reporting responsibility through the Comptroller, rather than through procurement or program management channels. There is no need to seek further independence in that role.

But DCAA auditors are more than advisors. The essential audit independence of DCAA inevitably puts it at odds with contractors, and sometimes with DoD acquisition people, in particular cases. So that differences will not unnecessarily or unreasonably delay the acquisition process or damage day-to-day working relationships, contracting officer disagreements with an auditor's advice which cannot readily be resolved at the working level are referred upward through a follow-up and resolution process overseen by the IG. In short, such differences become subject to internal audit controls. In his internal audit role, the IG audits DCAA's and the Defense acquisition community's compliance with DoD policy. Moreover, as the DoD's audit policy official, the IG sets the standards by which contract audits are conducted.

In summary, the present arrangement protects the necessary independence of DCAA and the IG from one another and from the acquisition community without jeopardizing the effectiveness of either the acquisition or audit processes. To integrate the two in a common organization could adversely impact on the contract audit mission. The Department, therefore, recommends against passage of H.R. 4568.

The Office of Management and Budget advises that from the standpoint of the Administration's program, there is no objection to the presentation of this report for the consideration of the Committee.

Sincerely,

William H. Taft

William H. Taft, IV
Deputy Secretary of Defense

Department of Defense

Office of the Assistant Secretary of Defense
(Comptroller)

Report On

The Activities of The

Defense Contract Audit Agency

For the quarter ended December 31, 1983

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Summary

Savings through Audit.

The Defense Contract Audit Agency (DCAA) is the designated independent financial advisor within the Department of Defense to Government negotiators and contracting officers, in connection with reviews of pricing proposals and establishing final prices under existing contracts. In this role, the audit efforts of the DCAA resulted in $8.982 billion in savings for calendar year 1983, in the following categories:

A. Type of Audit	Examined	Questioned	Exceptions Sustained
Forward Pricing Proposals	$254,835,800,000	$34,517,300,000	$8,270,000,000
Incurred Costs	45,192,900,000	1,309,200,000	640,200,000
Cost Accounting Standards	194,600,000	43,500,000	26,700,000
Defective Pricing	N/A	N/A	44,600,000
Total Exceptions Sustained			$8,981,500,000

N/A = Not Available

B. Potential Fraud Cases Referred to Investigative Agencies 74

The audit savings relative to forward pricing proposals are by far the most significant. For this reason, DCAA assigns the highest priority to such audit efforts in order to provide contracting officers with timely financial advice necessary for the negotiation of fair and reasonable contract prices.

The difference between the amount questioned and amount sustained results from various causes. The "give and take" of the negotiation process results in the reinstatement of some audit adjustments. A time lag occurs between when the costs questioned are reported and when they are negotiated. Additionally, not all forward pricing proposal audits result in sustained savings since, frequently, there are multiple responses to a request for proposal and only one contract is awarded. For this reason, direct comparisons between questioned and sustained columns are not appropriate.

The audit of incurred costs also results in savings not included in the DCAA reporting system. For example, audit findings sustained relative to contractor requests for progress payments result in interest savings to the U.S. Government. During the quarter two such audits alone resulted in imputed interest savings of $7.7 million.

Fraud, Waste, and Abuse

At times, review of contractors' incurred or proposed costs may also disclose a reasonable suspicion of fraud, waste, or abuse. When this occurs, appropriate investigative groups are notified promptly. For example, a DCAA auditor's discovery and reporting of suspected irregular conduct resulted in a successful fraud investigation of a Government contractor for filing false claims for inflated prices for spare parts. As a result of the investigation, the contractor recently pleaded guilty to filing false claims against the United States and paid fines, damages, and penalties totaling $3 million dollars. The company executive responsible for the fraud also pleaded guilty to felony charges and could be sentenced up to 25 years in prison. (Section B provides examples of potential fraud cases referred to investigative organizations during the reporting period.)

Spare Parts

DCAA has directed special attention to the spare parts pricing question. In addition to responding to contracting officer requests for reviews of specific spare parts proposals, DCAA has supported internal audit and Inspector General activities. Reviews are being made of the prices paid to 200 major contractors who supply spare parts. The objectives of this study include the determination of the extent to which contractors have been overpaid, identification of practices that caused the problem, and development of any necessary policy and procedural changes to improve the spares acquisition process.

A. SUMMARY RESULTS OF AUDIT FOR FIRST QUARTER FY84 (1 OCT.--31 DEC., 1983) AND 12-MONTH PERIOD ENDED 31 DECEMBER 1983

($ Shown Represent Millions)

Type of Audit	No. of Proposal and Other Audit Reports	Dollars Examined	Costs Questioned	Exceptions Sustained*
Forward Pricing Proposals				
Quarter	5,926	74,464.0	13,703.3	1,208.8
Year	28,374	254,835.8	34,517.3	8,270.0
Incurred Costs				
Quarter	Note (2)	9,071.2	342.7	37.1
Year		45,192.9	1,309.2	640.2
Cost Accounting Standards				
Quarter	Note (2)	80.7	19.4	0
Year		194.6	43.5	26.7
Defective Pricing				
Quarter	241	Note (1)	7.9	
Year	1,167			44.6

* Exceptions sustained represent those from current and prior periods because there is a time lag between the time exceptions are reported and costs are negotiated. Direct comparisons between questioned and sustained columns are not appropriate.

Yearly amounts include latest 12 months.

Note (1): Dollars examined and costs questioned are not normally reported in the defective pricing category. Reporting dollars examined would duplicate dollars reported as examined in the forward pricing proposal category. Defective pricing reviews contain recommended price adjustments -- not questioned costs.

Note (2): This information is not available on a quarterly basis. Only available on a management year (MY) or fiscal year (FY) basis.

B. POTENTIAL FRAUD CASES REFERRED TO INVESTIGATIVE ORGANIZATIONS DURING THE REPORTING PERIOD

	Number of Referrals	
	Quarter Ended 12/31/83	Year Ended 12/31/83
Procurement Fraud Category:	26	74
Labor Mischarging	10	26
Overstated Progress Payments/Public Vouchers	2	3
Proposal Misrepresentations	4	6
False Records		15
Postaward Audits	4	8
Violations Anti-Kickback Statute	1	1
Other* - such as false travel vouchers, theft of precious metals, equipment mischarges, etc.	5	15
Total	26	74

When DCAA encounters a situation where fraud is a possibility, its policy is to perform sufficient audit verification to establish the facts. When the results of the additional audit efforts reaffirm the possibility of fraud, a case is prepared and submitted to an investigative organization for action. The investigative organization evaluates the facts and determines whether the case should be pursued.

The following are examples of significant cases of potential fraud referred to investigative organizations during the quarter.

INCIDENT: Alleged Shifting of Costs Between Contracts. A review was completed of practices and procedures regarding a contractor's accounting for labor costs. The audit disclosed that about $1.3 million of labor costs were shifted from an overrun DoD contract to other Government cost reimbursement contracts. The mischarging involved: (i) improper time charges made by employees at the direction of supervisors; (ii) white-out changes made to timecards obscuring the nature of the charge; and (iii) significant inconsistencies between travel expense charges and the related labor charges. (Referred to Defense Criminal Investigative Service.)

INCIDENT: Irregular Labor Hour Transfers. A review of labor charging practices uncovered irregular labor hour transfers amounting to $170,000. The improper charges involved transfers from a DoD cost-type contract which was in an overrun condition to a contract which had ample remaining funds. Also, timecards for engineering and production personnel were altered by erasing or lining out the origignal job order/project number and substituting another number. (Referred to Air Force Office of Special Investigations).

INCIDENT: Employees Directed to Mischarge $3 Million in Labor Costs. A comprehensive labor review of labor charges revealed that significant labor hours, valued at about $3 million, were mischarged. The mischarging involved labor which was charged to the cost reimbursable portion of a contract but which should have been charged to the fixed price effort under the contract. Inquiry disclosed the mischarging was done at the direction of the employees' supervisor. The contractor has proposed a partial contract adjustment for the improper charges. (Referred to Air Force Office of Special Investigations.)

INCIDENT: Intentional Submission of Inaccurate Pricing Data. During the course of two postaward reviews, the auditor discovered that the contractor may have deliberately submitted inaccurate, incomplete, and noncurrent cost or pricing data in connection with contract negotiations. During the negotiations, the contractor had data which indicated that certain proposed estimating factors were significantly overstated. This resulted in inflating material costs by about $30 million. (Referred to Defense Criminal Investigation Service.)

INCIDENT: Withholding of Relevant Pricing Data. Excessive contract profits, approximately $16 million, are suspected to have resulted because of the submission of inaccurate, incomplete, and noncurrent cost or pricing data during contract negotiations. The Government negotiator relied on the contractor's statements that there would be a break in production with a resulting increase in manufacturing hours. However, the contractor's production scheduling records indicated that no break in production had occurred. Also, during another negotiation, the contractor failed to disclose that proposed spares orders had already been produced under another flexibly priced contract prior to the spares negotiations. Withholding of this information resulted in substantial overpricing. (Referred to Defense Criminal Investigative Service.)

INCIDENT: Deliberate Overbilling of Costs. During a review of a contractor's escalation claim proposal, the auditor discovered that the Government may have been deliberately overbilled by about $6 million in economic compensation adjustments. The contractor's accounting manual contained appropriate escalation billing policies and procedures which were not followed. (Referred to NASA Investigative Service.)

C. EXAMPLES OF SIGNIFICANT CONTRACT AUDIT FINDINGS AND RECOMMENDATIONS

1. Forward Pricing Proposal Audits.

Engineering Labor Hours. DCAA auditors reviewed a $201.3 million fixed price proposal submitted by a subcontractor to a Government prime contractor. The auditor's report provided information which was instrumental in helping the prime contractor reach a negotiated subcontract price of $117.3 million. A significant issue involved the use of parametric estimating techniques for projecting engineering labor effort. The auditor's analysis disclosed that the experienced labor hours used in the parametric formula were not reasonable as a basis for projection. The auditor found that the contractor had used experience from prior production lots having extraordinary technical problems. Another significant issue involved the cost proposed by the subcontractor of retaining knowledgeable personnel for use on future orders. The auditor questioned the entire amount proposed for this item. Both issues were sustained in negotiations.

Prime Contractor Analysis of Subcontractor's Proposals. DCAA's audit of a $697 million proposal for definitization of a letter contract resulted in savings of $45.2 million. The auditor found that the contractor had not performed cost or price analysis on many subcontractor proposals. DCAA auditors performed an evaluation to compute the average negotiated price reduction historically experienced with vendors and subcontractors. On this basis, the auditors questioned a significant amount of material cost. Review of labor hours disclosed that learning curves were improperly calculated primarily as a result of not including all available experience. The auditors also questioned various rates and pricing factors using regression analysis and projections of prior trends.

Duplication of Proposed Costs. A DCAA audit of a proposal to definitize a letter contract for "long lead" material items for a major weapon system resulted in savings of $41.2 million. This audit disclosed some duplication of cost proposed by the prime contractor and a subcontractor. The auditor also found that the material variance account contained costs which were not allocable to Government contracts. Audit results also disclosd that the contractor had failed to consider the availability of residual inventory from previous Government contracts.

Manufacturing Labor Hours. DCAA auditors reviewed a $528 million incentive fee proposal for the Space Shuttle Program, and acceptance of their recommendations saved the Government $50 million in target cost and incentive fees. A large portion of the questioned cost resulted from exceptions taken to the contractor's proposed manufacturing labor hours. The auditor found that the contractor's improvement curve for projecting labor hours was incorrectly calculated. The contractor's baseline hours, from which all projections were made, were based on estimates even though actual incurred hours from prior production lots were available. The auditor also found that the contractor had not taken into consideration that the rate of production was more than doubling, thus reducing the fixed hours per unit. The auditor adjusted for those conditions and projected significantly fewer labor hours.

Estimating Method For Material and Labor Hours. DCAA's evaluation of a $319 million fixed price proposal disclosed findings which resulted in $34.3 million savings to the Government. The auditors determined that the contractor's method for estimating material costs and labor hours resulted in substantially overstated costs. Material costs were estimated for this procurement by applying escalation factors to bill-of-material prices of a prior production lot. However, based on a statistical sample of actual purchase orders, the auditor found that material prices for this procurement were actually lower than the prices proposed for the prior production lot. The manufacturing labor hours were based on a learning curve for a different type production unit.

Engineering Labor Skill Mix. DCAA's evaluation of an $84.7 million fixed-price proposal for a follow-on production program resulted in a $10 million negotiated reduction. Among the many items contributing to the savings was the lower engineering labor cost recommended by the auditor. The auditor's analysis of engineering labor disclosed that the contractor had proposed a higher pay (skill) mix than what had previously been experienced for this type effort. Use of the auditor's more realistic labor mix resulted in a significant reduction of labor cost.

Purchased Parts Decrement Factor, Material Attrition Factors and Labor Improvement Curve Techniques. Savings of $5.[illegible] million were realized during a review of a $50 million fixed price proposal for Army Test Stations. The auditor's review of purchase parts history disclosed that the unit prices contained in vendor quotes were consistently higher than those actually paid to vendors. By developing a historical quote reduction factor, the auditor was able to support lower material cost estimates. The auditor also developed and calculated material attrition factors using historical cost records. These factors supported much lower material attrition than judgmentally estimated by the contractor. Additional savings were realized by using improvement curve techniques to project reductions in labor hours.

Payments to Vendor Below Quotes Submitted. Evaluation of a $61 million firm-fixed-price contract proposal for Air Force test equipment resulted in negotiated net savings of $5.4 million. DCAA's review of the contractor's purchasing experience showed that the actual prices paid to vendors were, on the average, lower than the prices initially quoted by those vendors. The auditor applied this experienced reduction factor to proposed material costs to project expected cost savings. The audit also disclosed that the contractor had overstated its indirect expense rates.

Escalated Material Costs. DCAA auditors saved the Government $3.2 million in incentive fee as a result of reviewing a proposal for a Space Satellite Program. The auditor found that the contractor had escalated material costs by applying various "allowance factors" which were judgmentally estimated and not supported by valid data. The factors were proposed to provide for engineering changes which might be made to production material. DCAA auditors established that these changes are normally recovered through the formal engineering change proposal (ECP) process and should not be proposed as part of the procurement. The auditor also found that travel and other direct costs were increased by escalation factors that were 4 to 6 times greater than factors developed by independent economic forecasters.

2. Incurred Cost Audits.

Progress Payments for Unfunded Subcontractors' Costs. A review disclosed problems with a major defense contractor's progress payment system. The auditors found that the contractor was in many instances, billing costs which were either excessive or ineligible for payment. This resulted in the contractor being reimbursed for costs prior to entitlement. For example, the auditors found that the contractor was reimbursing subcontractors and in turn billing the Government for contracted effort that had not yet been funded. As a result of the auditors' recommendations, changes were made that saved the Government $5.3 million in imputed interest cost.

Progress Payments for Allocated Central Stores Inventory Costs. A review of a major defense contractor's progress payment procedure resulted in savings of approximately $2.4 million in imputed interest costs. The contractor's procedures provided for allocating central stores inventory costs to Government contracts so that those costs could be billed as progress payments. The auditor found that the central stores inventory was excessive and that the procedure for allocating the costs to Government contracts was inequitable. The auditor recommended that the cost of excess material be excluded from allocation and that the contractor revise its allocation procedures.

Business Meetings and Employee Recognition Awards. The Defense Acquisition Regulation (DAR) makes allowable certain costs relating to employee morale, health and welfare, and business meetings. The nature of some of the activities is such that they generally involve costs which are unallowable under the DAR either by specific exclusion or by exceeding the intent of DAR allowability provisions. A recent review of such expenses revealed substantial amounts of questionable costs, such as expenses for employees (and, in some instances, their spouses) who attain certain marketing goals. The meetings were held in resort areas such as Hawaii, Nassau, and high cost locations in the continental United States. Typically, these costs were comprised of travel, hotel, live stage productions, and other entertainment. The questioned costs resulted in savings on Government contracts in excess of $2.7 million.

Independent Research and Development (IR&D). Public Law 91-441 requires the negotiation of an advance agreement with those contractors who receive $4.4 million or more from the DoD for independent research and development and bid and proposal costs in order to establish a limit over which such costs would not be allowable. During an audit of the classification of costs subject to the advance agreement, the auditor identified a significant amount of IR&D costs classified as manufacturing overhead. Since the contractor had exceeded the advance agreement ceiling on IR&D, the costs were not reimbursable. The contracting officer concurred with the audit findings and excluded $970,000 from the contractor's billable overhead.

Labor Mischarging. A "floor check" is a physical observation of work areas to determine that employees are actually at work, that they are performing in the assigned job classification, and that the time is charged to the appropriate job or contract. A recent "floor check" revealed that employees were actually performing effort on other contracts while charging their time to a Government cost-type contract. The contractor concurred with the auditor's findings and reduced its billings to the Government by $119,000. The contractor also agreed to increase the frequency of its own internal floor checks to preclude recurrence and prepare weekly reports monitoring the charges to cost-type contracts.

3. Operations Audits.

Computer System. Significant savings were realized as a result of a DCAA operations audit of a large Government contractor's computer system. The audit recommended increased use of minicomputers to fill the gap between manual operations and large scale computer operations. As a result of implementing the audit recommendations, initial savings of $2.9 million have been realized. The savings resulted from using minicomputers to increase employee productivity and from reducing the usage of large main frame computer services. Additional potential savings of several million dollars are also expected to materialize.

Inventory Control System. Auditors performed an economy and efficiency review of a contractor's inventory control system. The review disclosed that due to system inefficiencies, too much time was being spent searching for material and that costs incurrd for material storage and transportation were excesive. The auditor recommended the installation of an automated storage and retrieval system to eliminate these inefficiencies. Annual savings of $2.5 million will result from the contractor's agreement to implement the audit recommendations.

4. Defective Pricing Audits.

Inaccurate Data. During a postaward review, the auditors found that cost or pricing data submitted by the contractor at the time of negotiations was not current, accurate, and complete. The defective pricing consisted of (i) doubling the price of miscellaneous usage material by estimating it in a rate per production labor hour and also as a separate item, (ii) overstating material requirements due to use of noncurrent drawings and (iii) failing to update the proposal for the latest price quotes on material. The negotiator sustained 91 percent of DCAA's recommendd reductions, saving the Government approximately $1.1 million.

D. DCAA INITIATIVES.

The Assistant Secretary of Defense (Comptroller) gave DCAA a number of new management initiatives for the management year ending 30 June 1984. Areas of principal interest follow:

1. Using DCAA audit experience, identify specific cost principles that require clarification or revision to correct current problems. Recent field costing problems were correlated with applicable DAR Cost Principles and Cost Accounting Standards (CAS). Eight areas were identified that require clarification or revision to close "loopholes" or "voids" which result in excessive costs. The problem areas include gains resulting from the sale of assets under a business combination, several aspects of insurance costs, pension costs, compensated personal absences, employee stock purchase plans, and lease/depreciation costs. Recommended DAR changes have been developed but are being held pending the issuance of the Federal Acquisition Regulation (FAR) in April 1984. Recommended CAS revisions cannot be acted upon unless the CAS Board function is reactivated. CAS clarification changes are being acted upon.

2. Employ a series of new audit and reporting techniques for analyzing the contractors' total compensation package (salary/wage plus fringe benefits), and provide the contracting officer with a more meaningful range of advisory audit recommendations for use in contract negotiations. A compensation cost network was established within DCAA in order to keep Headquarters informed of field developments and to aid in the dissemination of guidance to our field auditors. DCAA selected and field tested a "three-point" alternative for our escalation recommendations in audit reports. Through the Joint Logistics Commanders' Advisory Group on labor and overhead costs, DCAA embarked on a project to accumulate and exchange all guidance issued by the services and Defense Agencies on compensation costs.

3. Undertake a new series of operations audits covering such contractor functions as equipment utilization, design changes, repair/rework/scrap, and travel procedures, to improve efficiency and reduce costs on defense contracts. A DCAA-wide operations audit workshop was held to exchange audit information and discuss alternative approaches for performing operations audit prototype reviews. Prototype reviews were made and detailed audit programs have now been provided to DCAA regions for field use. DCAA plans special emphasis in next year's program plan to incorporate lessons learned and associated benefits from effort under this initiative.

4. Reevaluate DCAA's approach to potential defective pricing instances to identify conditions which might be indicators of fraud. Auditors were requested to review positive defective pricing findings for indications of fraud based on the standards and conditions established in guidance issued. A detailed audit program that incorporates steps for the detection of fraud was also distributed.

5. Analyze the DCAA audit role in reviewing proposed subcontract costs on major weapon systems procurements. Contracting officers require timely and professional assistance in this complex and significant cost area and improvements in DAR instructions on contracting officer, DCAA, and prime contractors' responsibilities regarding audits of subcontractors may be necessary. A proposal for a special study of the related issues is underway.

E. ARMED SERVICES BOARD OF CONTRACT APPEALS (ASBCA).

Every Government contract includes a "Disputes" clause and is subject to the Contract Disputes Act of 1978 (P.L. 95-563). The Disputes clause establishes procedures to be followed when either of the parties seek, as a matter of right, payment of money, adjustment, interpretation of contract terms, or other relief on matters arising under or related to the contract.

The ASBCA is the designated representative of the DoD in hearing appeals arising under the Disputes clause. It provides an administrative process for settling disputes and its rulings are usually binding on the Government activitity involved. In most instances, contractors also accept the Boards' ruling as final. Since the Contract Disputes Act of 1978 became effective, the Boards of Contract Appeals have been empowered with the same judicial authority as the U.S. Court of Claims (now the Claims Court). Membership on a Board is limited to qualified attorneys who are designated as "Administrative Judges."

The disputes process can be entered by either party when the issue cannot be resolved through the usual negotiation process and, in fact, a prepondurance of disagreements are resolved without resort to the disputed process. Negotiation is not considered appropriate in certain instances, such as interpretation of the meaning or intent of cost principles; the application of Cost Accounting Standards, enforcement of statutory provisions (e.g., "defective pricing," P.L. 87-653), compliance with specific contract terms (e.g., billing limits or ceilings), and other disagreements whose resolution has precedent-setting implications. Because of these considerations, a significant percentage of the disputes heard by the Contract Appeals Boards result from issues raised initially by DCAA, as shown by the following summary of ASBCA cases on 31 December 1983:

Types of issue	No. of Cases
Defective pricing (P.L. 87-653)	29
Equitable adjustment	85
Cost Accounting Standards (P.L. 91-379)	14
Termination	20
Contract delay	26
Cost Principles (DAR Section 15)	26
Contract terms	10
Others	8
	218

Costs at issue under the above cases are in excess of $377 million.

Rulings by the Board of Contract Appeals are significant because they may establish judicial precedence for subsequent cost determinations and may become the basis for revision of the procurement regulation when they identify ambigious or faulty regulatory language which does not correctly represent DoD or Government policy. As a result, DCAA participation in the disputes process requires auditing and accounting abilities of the highest caliber in order that the Government evidence, supporting documentation, and testimony correctly and effectively present the Government's position.

During the quarter, several contractor appeals arising from DCAA findings or recommendations were docketed by the ASBCA. The following examples illustrate some of the complexities involved.

1. Are Air Show Expenses Advertising or Selling Costs?

A contractor's overhead proposal included $570,000 of costs incurred for the construction, operation and dismantling of a chalet at the 1979 Paris Air Show. In prior years, the contractor treated similar costs as unallowable advertising. All the costs now at issue were allocated to government divisions and charged against Government contracts.

The contractor now believes the chalet costs to be allowable selling expenses under DAR 15-205.37 and contends that the chalet served as a foreign sales office with activities designed to establish better association of the contractor's products with customer requirements.

The auditor believes that the chalet's operations involve all the unallowable activities cited in DAR 15-205.1, advertising, and especially, unallowable sales promotion. The auditor also considers part of the costs claimed to be entertainment, which is unallowable under DAR 15-205.11.

The ruling under the appeal will also affect $1 million claimed by the contractor in a subsequent year, as well as millions of dollars incurred by other contractors who had similar chalets.

2. Are Employee Rebates a Legitimate Cost?

A contractor changed its accounting treatment of employee discounts (rebates) on the company's commercial products. Employee discounts were previously treated as a reduction in sales of the segment that manufactured the product. The discounts are now treated as an employee fringe benefit and charged as compensation costs of the segment employing the rebatee.

The contractor contends that the rebate program results in fringe benefits allowable under DAR 15-205.6(m) in that the rebates are an "allowance ... provided by the contractor to its employees as compensation in addition to regular wages and salaries."

The auditor believes that the rebates do not constitute a cost but are a reduction of the manufacturing segment's sales. DAR cost principles are silent with regard to either position; accordingly, the matter must be resolved in accordance with generally accepted accounting principles.

The ruling on the case will affect future years' cost reimbursement of this contractor and has potential for application to all contractors who grant such discounts or rebates on their commercial products.

3. Are Corporate Aircraft Costs Reasonable?

Operating costs for a contractor's aircraft increased from $3 million in 1974 to $9 million in 1977. A prime reason for the increase was the acquisition of a Boeing 727 reconfigured to accommodate only a fraction of the capacity of the commercial version. Audit and technical studies indicate that some $2.3 million of such costs represent costs in excess of cost for commercial airline use and are therefore, unreasonable and unallowable.

The contractor argues that the excess costs being disputed are offset by advantages such as otherwise unavailable en route sleeping accommodations and greater flexibility of travel arrangements.

The auditor contends the costs are unreasonable because the contractor has not demonstrated that the increased cost, when compared with alternative means of transportation, is commensurate with the advantage gained.

4. Did The Government Cause The Delay?

A contractor was awarded a contract for $860,000 to provide computer equipment. During contract performance, the contractor requested a price change due to alleged Government actions. The contracting officer denied the claim and terminated the contract for default when the contractor failed to deliver the equipment.

The contractor claimed that the Government delayed and hindered performance on the contract and requested a $1 million increase in the contract price.

The auditor determined that the claim was not substantiated and was not supported by adequate documentation. The audit also disclosed the contractor to be in financial difficulty on this contract as well as other work.

The contractor has subsequently submitted two additional claims totalling $3.6 million.

F. DESCRIPTION OF MAJOR AUDIT AREAS.

1. Forward Pricing Proposal Audits - The Defense Acquisition Regulation requires contracting officers to request a field pricing report (which usually includes an audit review) prior to the negotiation of a contract or modification resulting from a proposal in excess of $500,000, when the price is based upon cost or pricing data submitted by the contractor, unless the contracting officer has information available to determine the reasonableness of the proposed cost or price. As a result, DCAA is requested to audit most prime contractor proposals and is involved in the audit of many of the underlying subcontracts.

Inherent in this activity is knowledge of the contractor's estimating and accounting systems so that the strengths and weaknesses of the contractor's proposal can be identified. The audit must include an evaluation of the contractor's proposed cost data including the forecasting factors used. The auditor is also required to develop alternative approaches when the contractor's position is deemed unrealistic and/or unreasonable. All this effort is designed to provide the contracting officer with the financial information necessary for the negotiation of a reasonable contract price.

2. Incurred Cost Audits - All cost type contracts and all fixed price contracts with either redeterminable, incentive, or economic price adjustment provisions require DCAA audit for use in the final determination of the contract price. Audit determinations of cost allowability are performed in accordance with the cost principles contained in DAR Section XV, Part 2, incorporated in all such DoD contracts by reference. This regulation establishes the criteria by which a contractor's incurred cost may be deemed an allowable and allocable charge to the Government contract. It covers, for example, direct materials, subcontracts, and direct labor as well as overhead and general and administrative charges.

3. Operation Audits - DCAA performs operations audits which are somewhat comparable to management services performed by CPAs. All operations audits have the common thread of systems analysis and effectiveness of operations as their primary objective. This expansion of audit services has become necessary due to the increased complexities of modern business and it is basically an extension of the financial audit.

Operations audits primarily relate to the functional elements of the contractor's organization and are directed toward the Government's benefit from the function as well as whether it is performed in an economical and efficient manner. The major distinguishing characteristic of this type of audit is its primary emphasis on prospective or future costs. The process envisions corrective action being taken by the contractor to avoid the incurrence of unnecessary cost. This results not only in savings on current contracts but the saving is also recognized in the pricing of new contracts.

For the 6-month period ending 31 December 1983, DCAA completed 101 operations audits with a total associated annual cost avoidance of $96.5 million.

4. Defective Pricing Audits - Public Law 87-653 provides that a prime contractor or subcontractor shall be required to submit cost or pricing data prior to the award of any negotiated prime contract, modification, or subcontract in excess of $500,000, and shall be required to certify that to the best of his knowledge and belief, the cost or pricing data submitted was accurate, complete, and current. DCAA selectively audits contract awards subject to this mandate to determine whether the contractor meets the requirements of the law.

G. ORGANIZATION AND RESPONSIBILITIES

1. Establishment

The Defense Contract Audit Agency (DCAA) was established as a separate agency in the Department of Defense in 1965 to provide independent, objective, and consistent advisory audit recommendations to procurement personnel regarding contractor costs, and to effect other operating improvements. Its Director, Mr. C.O. Starrett, Jr., reports to the Assistant Secretary of Defense (Comptroller).

2. Mission

DCAA is the principal financial advisor to Government negotiators and contracting officers in connection with negotiating new contract awards and establishing final prices under existing contracts. As such, it performs an operational function as contrasted with the audits and investigations performed by the internal audit agencies and the Office of the Inspector General. Like the internal audit agencies, DCAA is subject to review and oversight by the Inspector General.

The Agency audits costs proposed or incurred by approximately 13,000 contractors. The results of the audits are provided to procurement and contract administration components within the military departments and defense agencies for use in negotiation, administration, and settlement of contracts and subcontracts. Contract audit services are also furnished to a number of other Government agencies to avoid duplication of effort and achieve optimum use of Government resources. DCAA performs almost all contract audit work required at contractor plants for the entire Federal government.

3. Organizational Structure

DCAA functional activities are geographically dispersed. Resident offices have been established at 56 contractor locations where the audit workload justifies the assignment of a permanent staff of auditors. The agency has also established 71 branch offices and 283 suboffices which are strategically located to handle all DoD contract audit work within assigned geographical areas.

As of December 31, 1983, DCAA had a workforce of 3,764 employees. Of this number, 3,079 are professional auditors, and 685 are administrative support personnel. Of the auditors, 585 have achieved professional accreditation as Certified Public Accountants and 177 have passed the examination and will become certified when they meet the experience requirements.

4. Defense Contract Audit Institute

Since 1967, DCAA has operated the Defense Contract Audit Institute (DCAI) in Memphis, TN, to address its specialized audit needs. Twenty courses have been developed to contribute to carefully designed and monitored career development plans. These courses are tailored to the complex accounting/audit environment in which the auditors operate at contractor locations, and emphasize innovative audit techniques.

As an example, a new Information Systems and Data Retrieval course was developed recently. In this course, students learn how to use COSAM and DATATRAK software packages to select samples and retrieve data in desired formats directly from the contractor's computer. This is a "hands-on" problem-solving course where students identify various forms of mischarges contained in a simulated accounting system using DCAI in-house computers.

The Planning and Performance Skills course was devised so that students can use a microprocessor and a Visi-Calc Spreadsheet Program to make various "what if" calculations when working on a requirements and program plan case study. The use of this technology significantly improves the planning process.

The DCAI provides instructors to make presentations to the participants of the DoD IG's Procurement Fraud Course. Training DoD investigators in the accounting process related to fraud, waste, and abuse will facilitate the detection and resolution of suspected irregularities.

More than 130 classes of short duration have been scheduled for fiscal year 1984, and a total of 2,775 students will attend the Institute during that period. Courses offered include such subjects as:

Statistical Sampling
Cost Allocation Principles
Advanced Audit Techniques for Managers
Graphic, Computational and Improvement Curve Analysis
Information Systems and Data Retrieval
Auditing Contractor Data Centers
Electronic Data Processing
Risk Assessment
COBOL for Auditors
Auditing Pension Costs
Planning and Performance Skills

Chairman ROTH. At this time we would call forward Mr. O'Connor, the Special Counsel for the Merit Systems Protection Board.

TESTIMONY OF K. WILLIAM O'CONNOR, SPECIAL COUNSEL, MERIT SYSTEMS PROTECTION BOARD

Chairman ROTH. Mr. O'Connor, I understand that you do not have any prepared statement but are available for questions.

Mr. O'CONNOR. Absolutely, Senator. Thank you for having me.

Chairman ROTH. You recently completed an investigation of various allegations in the George Spanton case. It is not appropriate, and I would call to the attention of my colleagues, we do not intend today to get into that case. But I know that during your investigation you found a number of problems in the management of DCAA, and you stated on August 31 of last year that evidence indicates a pervasive attitude at DCAA that reflects undue regard and solicitude for the concerns of contractors and procurement officials in the audit process.

What led you to this conclusion, and can you be specific?

Mr. O'CONNOR. I will try, sir. I, of course, appreciate your respect for my position as prime trial counsel in the case against certain officials of DCAA, including Mr. Starrett, which is now pending.

The preliminary inquiry before litigation was under way was considerably broader than the litigation actually presented, so I will address myself to those segments of the preliminary investigative action by my office which were not directly related to the matter which is presently pending in litigation and thus, I think I can answer your question.

Before making the decision as to whether or not litigation should be brought, I caused investigators to make inquiry of a variety of witnesses in DCAA and elsewhere to determine whether or not the attitudes which were expressed in certain complaints which I received were endemic or were not, were systemic or were not.

The responses which I received—and I am not speaking about Mr. Spanton or any of the witnesses who testified in that case—was that the attitudes generated by DCAA management toward the field audit staff were that the field audit staff had better get along with the contractor and that not getting along with the contractor was a serious problem for the DCAA, and that those who did not get along with the contractor sometimes found their situation less beneficially handled than had they gotten along.

That did not mean that the auditors should lie down and play dead. What I understood it to mean was that it told them that it was important for them not to create unnecessary ruffled feathers. That ties to what Mr. Sherick said in this hearing about decentralization, because the ripple effect was that the furthest extremities at DCAA, the ability to avoid problems became a significant and endemic condition in that entity.

Chairman ROTH. What you are saying to me is that it is this type of attitude that really destroys the effectiveness of any audit agency.

Mr. O'CONNOR. Senator, auditors told us of circumstances where they were called on by their management, and I am not speaking of Mr. Starrett, and told that if they didn't get along, they were going to have other assignments. Auditors told us of problems where they had been perceived by contractors as being too aggressive in demanding access to records of the contractor which they believed they were entitled to have under the provisions of the contract, and they were either not supported by management or were advised that this aggressiveness was not a desired procedure and that they should make do with what they could get and qualify their audits.

I have been an Inspector General. I don't think much of qualified auditing as a mode of presenting the Government's position, and so I will share with Mr. Sherick the view that qualified audits are not terribly useful, depending on the level of qualification, of course.

Chairman ROTH. When you are talking about qualified audits, what you mean is that some of the information essential for performing an adequate audit has been denied the auditor, and therefore instead of being completed, it is released as an incomplete report; isn't that correct?

Mr. O'CONNOR. I think it puts the negotiating executive, in this case, perhaps the procurement officer who carried the Government's warrant as has been established, at a position of significant disadvantage.

That procurement executive would ordinarily be caught between Scylla and Charybdis in that on the one hand, he is being pressed to obtain the contract to make the weapons system desired available, and on the other hand, he is being pressed not to go ahead because he doesn't know enough about what it is that he should know in order to make a good negotiation happen for the Government.

Chairman ROTH. But isn't it a fact that as long as you proceed with qualified audits the situation is going to continuously deteriorate because there is no reason for a contractor to be concerned since he knows that he can still negotiate?

I agree with you. Maybe a contracting officer who is unusually bright and effective might still be able to negotiate a reasonable contract, but basically, adequate financial information as to cost is essential to a negotiation. If you don't have that, you are placing the contracting officer in an untenable position in many cases, and if he doesn't insist on that information, then you are just encouraging people not to supply it.

Mr. O'CONNOR. I think that that is true, and one of the results of inquiries which we made supports what Mr. Sherick has said here this morning about this problem being one that has gone on for a very long period of time. The access question is one that DCAA has been aware of for years and years, and I obtained a variety of documents reflecting internal concerns of the highest order in DCAA about access.

DCAA, however, labors, in my view, under a very serious impediment, and that impediment is that it has no subpena authority. When I was inspector general of one of the agencies, I had the occasion to—I guess you could call it rent-a-cop DCAA auditors. I found them to be—and these were men of career status in DCAA. I found them to be excellent auditors, and when given subpenas in order to obtain records that were witheld from them in their work for me as IG, they did excellent work.

DCAA does not have a subpena authority, and therefore, it is in a position where the only thing it can do is discuss the issues which have been presented here this morning.

Chairman **Roth**. Moving on, did your investigators experience any problem gaining access to necessary DCAA files?

Mr. **O'Connor**. I think that there was no great difficulty in getting access. It was widely known that the investigators from my office were able to issue subpenas and take testimony under oath, and they did those things when there was any need to do so.

Chairman **Roth**. Did DCAA have adequate and good headquarter records on fraud reports, or were they scattered and hard to find?

Mr. **O'Connor**. The information that was brought to our attention indicated that the system was varied. In some cases, they had pretty good records, and in some cases, I think there were some reports that had gotten lost in the shuffle.

Chairman **Roth**. Does that suggest that there wasn't a standard operating procedure?

Mr. **O'Connor**. Either that there wasn't a standard operating procedure or that it was disobserved by those responsible for it or badly managed. One of those would have to be the reason. I didn't have a charter to inquire into that question.

Chairman **Roth**. Senator Levin?

Senator **Levin**. Thank you, Mr. Chairman. Getting back to that subpena power issue, the ability of the DCAA to get information, DCAA is part of DOD. DOD has the greatest subpena in the world. It is called no information, no check.

Mr. **O'Connor**. I agree. Money is a very powerful lever. It isn't pulled often.

Senator **Levin**. It isn't pulled often; I have to agree with you. I don't think we use the existing weapons that we have. I don't have any great problem with giving DCAA subpena power anyway. I was just wondering how much it would be used when the Defense Department doesn't use existing weapons to get information; there are two critical weapons. First, if you don't give us the information, you don't get progress payments.

I tell you, that will provide the information. The second weapon is, if you don't give us the information, you don't get a contract. We have continued under the contracts for contractors who refuse to give us information. We do it all the time. We have done it through the years.

The DOD has the power to do it. They don't exercise it very often. Would you agree with that?

Mr. **O'Connor**. I would agree that they don't exercise it very often within my experience, and I would agree that they have the power, yes, sir.

Senator **Levin**. So I don't have any great difficulty offhand with a subpena. I don't know about the procedures that would be used, however. It just strikes me, though, that what you need are contracting officers who are caught in between, as you pointed out, who are going to say, basically, to their bosses, "We are not going to proceed in this deal with this contractor; we don't have an unqualified audit."

Why don't the contracting officers tell that to their bosses?

Mr. O'CONNOR. I think they should, Senator Levin. However, the experience that I have seen in the course of the nonlitigative aspect of the investigation that we did before litigation is that that doesn't happen. The general practice has been that such things occur as the tolerance of floor visits, being accompanied by corporate personnel. The tolerance is that DCAA auditors would not be allowed to make a surprise visit to the floor of a corporation; that he or she will not be allowed to ask questions of the persons who are running the corporation, machinery, and so forth, and the result, I suppose, is the widget that Senator Percy disclosed.

Senator LEVIN. My question of you is why, when we have a contracting officer who receives the qualified audit, the inadequate, incomplete information, why doesn't that contracting officer simply say no? The answer is because there is some pressure on him to buy the dam system, isn't it?

Mr. O'CONNOR. I don't know, but I would assume that if the system is needed, the contracting officer's duty is primarily to get it.

Senator LEVIN. So his or her boss at the DOD is telling that contracting officer, "You go ahead and buy it anyway despite that qualified audit."

Mr. O'CONNOR. I would not be in a position to answer that question, Senator Levin, because I have not conducted that kind of inquiry inside of DOD. But that would seem reasonable.

Senator LEVIN. I think that is where the problem lies. I think the DCAA has got plenty of problems. It can use some restructuring, and Mr. Sherick indicated some possibilities. There are a couple of bills that have been introduced to provide for some restructuring. I think something is going to be required. Basically, the problem is that DOD does not exercise the clout that it has right now over contractors, telling them, "No check, no contract in absence of information." As long as the DOD does that, the odds are that the DCAA won't even exercise the subpena power anyway, because that is part of the DOD.

Mr. O'CONNOR. You could exercise subpena power without jeopardizing the procurement of systems, and you could, after finding by the process of subpena power that there was something wrong with the payment, you could withhold funds from the corporation that had made the improper charges and recover the funds back. That could be done.

Senator LEVIN. If that is true, and I think it is, then you could also refuse to give a check, payment on a contract, or you should refuse to enter into a contract without jeopardizing the procurement system.

Mr. O'CONNOR. I would have a hard time getting a system out on contract.

Senator LEVIN. I would have a hard time getting a system without getting the system information. You would have a hard time without complying with the subpena.

Mr. O'CONNOR. I would agree, Senator Levin, that the power of the contracting officer is the one that gives the most strong cutting edge to the Defense Department's procurement position.

Senator LEVIN. Just to summarize, the DOD does not exercise the power that it has to get critical information right now.

Mr. O'CONNOR. I can't evaluate DOD's functions in that area. All I can do is talk about matters that came to my attention collaterally when I was in the process of conducting an investigation that is already pending in litigation.

Senator LEVIN. I understand your conclusion. I am just telling you my conclusion is based on what I think must be obvious here; we have got a qualified audit with inadequate information. The DCAA has done, it seems to me, providing they make a recommendation not to proceed, what they have been tasked to do.

The next task is up to that contracting officer. If he proceeds with qualified information or incomplete information as far as I am concerned, that is where the breakdown occurs.

Mr. O'CONNOR. I think that is the full area of inquiry, Senator Levin.

Chairman ROTH. Thank you, Senator Levin.

Just a couple of further observations.

Mr. O'CONNOR. Yes, sir.

Chairman ROTH. First of all, it is my understanding that the IG has offered to back up with his subpena power any requests for information that DCAA has, so that internally that power is available. Is that correct, Mr. Sherick?

Mr. SHERICK. Yes, sir, but I agree with Senator Levin; holding a check.

Chairman ROTH. I am not arguing with that at all.

Mr. SHERICK. Yes.

Chairman ROTH. I think that my concern is that it doesn't really make any difference what authority we give to DCAA. I share the concern Senator Levin has, that unless those responsible for negotiating and administering contracts are willing at the top side to make some tough decisions including withholding of pay, it doesn't make much difference what we do. I did want to point out that this authority is available within the Department of Defense if the DCAA really wanted to use it.

Again, my concern is not so much one of having a problem with the general quality of auditing, my concern is with the management of DCAA.

Mr. O'Connor, I do want to emphasize that I understand that you can't answer detailed information because of the pending litigation involving the Spanton case, but as soon as that matter is resolved we would like to submit a letter to you for additional information and details, if we might.

Mr. O'CONNOR. Very good, Senator. I would be happy to provide it, and I might note that the briefs that we have to be filed in this matter will be filed in the middle of this month. I will be happy to provide those if the Senator wishes them.

Chairman ROTH. That would be, as I understand, March 19?

Mr. O'CONNOR. Yes, sir.

Chairman ROTH. Thank you. We appreciate your being here today.

Mr. O'CONNOR. Thank you, Senator.

[The information submitted by Mr. O'Connor follows:]

UNITED STATES OF AMERICA
MERIT SYSTEMS PROTECTION BOARD

No. HQ12068310022

SPECIAL COUNSEL,

Petitioner,

v.

CHARLES O. STARRETT, Jr.
PAUL EVANS
ARLIN R. TUELLER,

Respondents.

* * * * * *

JAMES R. BROWN (Severed)

On Complaint for Disciplinary Action

POST HEARING BRIEF IN SUPPORT OF COMPLAINT

I.

JURISDICTION

In this disciplinary action, the three respondents are charged with violating the Civil Service Reform Act by taking reprisal upon George Spanton, a whistleblower, for his protected disclosures. They were also charged with violations of civil service rules and regulations for particular actions. The details of the charges are set out *seriatim*.

A. Charges Against Respondent Starrett

Charles O. Starrett, Jr., Director of the Defense Contract Audit Agency (DCAA), is charged with the commission of a personnel practice prohibited by 5 U.S.C. § 2302(b)(8). Count Two of the Complaint for Disciplinary Action filed on August 31, 1983 under 5 U.S.C. § 1206(a)(1) and (g)(1) charges that Starrett denied a rotation waiver request of then DCAA Resident Auditor George R. Spanton* and ordered his geographic reassignment in reprisal for Spanton's protected disclosures of information.

In Count Three of the Complaint, Starrett was charged with impeding Government efficiency and economy as well as adversely affecting public confidence in the integrity of the Government in violation of civil service regulation. 5 C.F.R. § 735.201a(c), (f); 5 U.S.C. § 1206(e)(1)(D)** (g)(1); *infra* at III, B. Specifically, Starrett was charged with negligently accepting and employing a patently unsubstantiated DCAA report of investigation made at his direction as a basis to deny Spanton's rotation waiver request and to order his geographic reassignment on or about March 10, 1983.***

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* On December 31, 1983, Spanton, a 63 year-old GM-14 competitive service employee, retired from DCAA.

** Subsection 1206(e)(1)(D) states in pertinent part: "In addition to the authority otherwise provided in this section [1206], the Special Counsel shall . . . conduct an investigation of any allegations concerning . . . activities prohibited by any civil service law, rule, or regulation . . . ." *See also* 5 C.F.R. § 1251.1(b)(4).

*** The Administrative Law Judge dismissed Count 3 of the Complaint as it applied to Starrett ruling that negligence was not conduct proscribed by 5 C.F.R. § 735.201a. TR X, 89(11)-90(15); TR XII, 125(1-19).

B. Charges Against Respondent Evans

Paul Evans, Director of the Atlanta Region, Defense Contract Audit Agency (DCAA), is charged with the commission of a personnel practice prohibited by 5 U.S.C. § 2302(b)(8). Count Two of the Complaint for Disciplinary Action filed on August 31, 1983 under 5 U.S.C. § 1206 (a)(1) and (g)(1) charges that Evans recommended denying the rotation waiver request of then DCAA Resident Auditor George R. Spanton and recommended directing Spanton's geographic reassignment, with knowledge of and in reprisal for Spanton's protected disclosures of information.

In Count Three of the Complaint, Evans is charged with impeding Government efficiency and economy, as well as adversely affecting public confidence in the integrity of the Government in violation of civil service regulation. 5 C.F.R. § 735.201a(c), (f); 5 U.S.C. § 1206(e)(1)(D), (g)(1); *infra* at III, B and IV, E. Evans is charged with making a false statement to the Office of the Special Counsel during an investigation into matters within its statutory jurisdiction. Specifically, Evans is charged with having falsely denied having made settlement of Spanton's pending EEO complaint contingent upon Spanton's offer to retire from DCAA.

In Count Four of the Complaint, Evans was charged with violation of Civil Service Rule V, 5 C.F.R. § 5.4. Evans was charged with refusing to subscribe his statement, on or about February 23, 1983, as requested by investigators of the Office of the Special Counsel.*

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* During this hearing conducted in Washington, D.C., the Administrative Law Judge ruled that 5 C.F.R. § 5.4 contained no proscriptive provisions and therefore the Special Counsel, under 5 U.S.C. § 1206(e)(1)(D), was without authority to enforce it. TR I, 43(2)-44(13).

C. Charges Against Respondent Tueller

Arlin R. Tueller, Special Programs Manager of the Atlanta Region, Defense Contract Audit Agency (DCAA), is charged with the commission of a personnel practice prohibited by 5 U.S.C. § 2302(b)(8). Count Two of the Complaint for Disciplinary Action filed on August 31, 1983 under 5 U.S.C. § 1206(a)(1) and (g)(1) charges that Tueller recommended denial of the rotation waiver request of then DCAA Resident Auditor George R. Spanton and recommended Spanton's geographic reassignment, with knowledge of and in reprisal for Spanton's protected disclosures of information.

In Count Three of the Complaint, Tueller is charged with impeding Government efficiency and economy, as well as adversely affecting public confidence in the integrity of the government in violation of civil service regulation. 5 C.F.R. § 735.201a(c), (f); 5 U.S.C. § 1206(e)(1)(D), (g)(1); *infra* at III, B and IV, E. Tueller is charged with providing false information to his supervisors that Spanton issued a forward pricing labor rate report without authorization. He is also charged with requesting an executive of Pratt & Whitney Aircraft to seek Spanton's reassignment from DCAA's West Palm Beach, Florida facility. 5 C.F.R. § 735.201a.

D. Basis for Jurisdiction

The Merit Systems Protection Board has jurisdiction to receive and adjudicate the complaint against Starrett, Evans and Tueller. 5 U.S.C. § 1207(a). The Board may delegate authority to an administrative law judge to hear an action brought by the Special Counsel and issue a recommended decision. 5 U.S.C. § 1205(b); 5 C.F.R. § 1201.129(a).

Until his retirement in December 1983, Spanton was employed in a "covered position" in an "agency" as defined in 5 U.S.C. §§ 105, 2302(a)(2)(B) and (C). Tueller's and Evans' recommendations, and Starrett's decision, to deny Spanton's rotation waiver request and to order his geographic relocation pertained to a "personnel action," specifically, a "reassignment," under 5 U.S.C. § 2302(a)(2)(A)(iv).

At all relevant times, Starrett has been an "employee" under 5 U.S.C. §§ 2105, 2302(b), serving as Director of DCAA, a covered independent agency of the Department of Defense, an executive agency. 5 U.S.C. § 2302(a)(2)(C). In that capacity, Starrett had authority to take, direct others to take, recommend, or approve personnel actions affecting George R. Spanton. *See* 5 U.S.C. § 2302(b).

At all relevant times, Evans has been an "employee" under 5 U.S.C. §§ 2105, 2302(b), serving as Director of the Atlanta Region, DCAA, a covered independent agency of the Department of Defense. 5 U.S.C. § 2302(a)(2)(C). In that capacity, Evans had authority to take, direct others to take, recommend, or approve personnel actions affecting George R. Spanton. *See* 5 U.S.C. § 2302(b).

At all relevant times, Tueller has been an "employee" under 5 U.S.C. §§ 2105, 2302(b), serving as Atlanta Regional Audit Manager (RAM) at DCAA, a covered independent agency of the Department of

Defense. 5 U.S.C. § 2302(a)(2)(C). In that capacity, Tueller has had authority to take, direct others to take, recommend, or approve personnel actions affecting George R. Spanton. *See* 5 U.S.C. § 2302(b).

II.

STATEMENT OF FACTS

A. Background

George Spanton, now 63 years old, was employed as a Supervisory Auditor GS/GM-14 by DCAA from its inception in 1966 through his retirement on December 31, 1983. TR I, 51(21)-52(2), 55(9)-56(8), 56(23)-57(5); CX 2; CX 3. He completed 30 years of federal service in May 1980. TR I, 83(22)-84(8); CX 10. Spanton had been geographically reassigned five times during his 30 years of federal service but had resided in West Palm Beach, Florida during his entire career with DCAA. TR I 58, 59(15-18), 67(9-22). From March 1978 until his retirement on December 31, 1983, Spanton managed the Field Audit Office (FAO) maintained at the Government Products Division (GPD) of Pratt & Whitney Aircraft, United Technologies Corporation, West Palm Beach, Florida. TR I, 51(21-23), 56(3-4), 62(8-12).*

In May 1980, Spanton became eligible to retire after completing 30 years of service. TR I, 83(22)-84(8); CX 7; CX 10. Paul Evans, DCAA Atlanta Regional Director since 1972, discussed retirement with Spanton at a DCAA meeting in Fort Worth, Texas in late August 1980. CX 10; CX 43, p. 6; CX 146, pp. 17(10-16), 20(21-25), 34(12-23), 70(2-9).

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* The facts that follow up to Section II, B *infra* provide a context for Spanton's disclosures in August 1982. Testimony of respondent James R. Brown from the *Brown* hearing (severed) was incorporated into the record of this proceeding by the ALJ. TR IX, 178-181.

Evans met with Spanton in a Fort Worth motel room where Evans pressed Spanton to retire and, when Spanton said he was not financially able to retire, began to criticize Spanton's performance. CX 41.

Spanton had a documented distinguished and productive career at DCAA and Evans' criticism was unexpected. His annual performance ratings were invariably above established standards. CX 6. In his capacity as a Regional Supervisory Auditor between 1972-1978, Spanton frequently received compliments from Evans. TR I, 94(9-17). Performance appraisals, signed and approved by Evans, Cali and/or then Assistant Regional Manager Jack D. Brookhart, consistently documented Spanton's excellent technical abilities; strong support for and successful implementation of DCAA objectives and policies; and effective work relationships.* CX 6, pp. 36-45. Spanton's favorable FAO Annual Reports were submitted to and accepted by Evans and forwarded by Evans to Headquarters. TR I, 112-13; CX 12; CX 13.

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* During the consolidated portion of the hearing, counsel for respondents, in varying degrees, disclaimed that they intended to challenge Spanton's job performance or competence as auditor/manager and, accordingly, sought to stem discussion pertaining to that subject. TR I, (89-93).

The following narrative remarks from Spanton's appraisals typify his performance and standing in the DCAA Atlanta Region: "Mr. Spanton's technical abilities are outstanding, and he enjoys the respect of both Government and contractor personnel" CX 6, p.43; "Mr. Spanton continues to manage his FAO in a competent and effective manner. His personal efforts have resulted in significant productivity gains" CX 6, p. 40; and, "Mr. Spanton's emphasis on productivity has again shown itself in his office's statistics for MY 1980. His gains in this area, attendant with his continual stress to increase quality of audit, are commendable." CX 6, p. 36. Also, on January 17, 1980, Evans (and Cali) awarded Spanton a $1,000 Special Achievement Award for his direction and personal involvement in an extremely sensitive procurement fraud audit (with "worldwide ramifications") at Homestead Air Force Base, Florida. TR I, 114(4-11); CX 9, pp. 1-3; CX 14. On May 12, 1980 Evans wrote to Spanton to personally commend him for his "contributions . . . in support of the Government and this Agency" and expressing "personal appreciation for [Spanton's] loyal service. . . ." CX 10; and, on October 7, 1980, Evans co-signed Spanton's Assessment of Promotion Potential which gave him top score of "excellent" in many areas including technical competence and productivity/work product, and second top score of "good" in areas such as management support, supervision and administration. CX 6, p. 38.

During the Fort Worth meeting in August 1980, Evans called Spanton's management practices outdated and recited a list of DCAA officials who, he said, had concurred that Spanton should retire immediately.* CX 42, pp. 13-14; CX 146, pp. 11-18.

Evans has admitted planning with Brown, Cali, Brookhart and Oyer** the discussion he had with Spanton about Spanton's prospective retirement at the Fort Worth meeting, but he denied expressing hostility. Evans said that he asked Spanton about his plans because a new Regional Audit Manager (RAM), Arlin Tueller, was soon to be named. TR XI,

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* Evans' list included Starrett and Brown. Evans had previously advised Brown of his planned discussion of retirement with Spanton. TR VIII, 37(22); CX 42, p. 13; CX 43, pp. 4, 6, 8; CX 44, p.1; CX 146, p. 79(11-17).

Spanton, upset by Evans' unforeseen criticism and pressures to retire, cancelled plans to go fishing with his son (who had accompanied him to the Fort Worth meeting) and returned home to Florida. CX 42, p. 14. Spanton felt that his services were unwanted and filed an application for retirement, which he soon withdrew upon reconsideration after being home for several days. CX 41, pp. 2-3.

** Joseph Cali was Spanton's immediate supervisor, RAM, at this time; Jack Brookhart was Evans' deputy; and Darrell Oyer was a former regional official who had moved to DCAA headquarters.

127-131. Evans also admitted that about the time of the Fort Worth meeting he gave permission for Oyer at DCAA headquarters to brief incoming RAM Tueller on the situation at the West Palm Beach/FAO. TR XI, 128(16-25); CX 43, pp. 7, 8. He admitted that he criticized Spanton's management of his FAO in the meeting. CX 43, pp. 7, 8. Evans further admitted that he had used the same technique of severe criticism in the past in dealing with other managers with supposed performance/management problems who became eligible to retire. CX 43, p. 8; CX 146, p. 75(17-25).

Spanton reported this conversation to others, including Jay Moyes (Chief, Contract Administration Division of the Air Force Plant Representative Office [AFPRO]) and Jack Brookhart shortly after it took place. TR IX, 120; TR X, 18. On the morning after the August meeting in the Fort Worth motel room, Evans once again inquired of Spanton as to his retirement plans. CX 41, p. 2; CX 146, p.74(25)-75(6).

On April 13, 1981, for the first time in his more than 30 years of federal service, Spanton filed a formal complaint against a supervisor. TR II, 79(23)-80(1); TR III, 47(18-21); CX 41; CX 42. In an EEO complaint, Spanton accused Evans of age discrimination by attempting to coerce his retirement, and by denying annual leave restoration. CX 41; CX 42. Evans was a witness for himself; and Brown was a witness for both DCAA and Evans in the investigation of Spanton's EEO complaint. Brown was also the ultimate agency deciding official; he ruled against Spanton on December 9, 1981. TR VI, 28-31, 36(2-18); CX 43-45; CX 51. Brown thus was, as he admitted at the hearing, both a witness against

Spanton and the judge of Spanton's EEO complaint. TR VI, 36(16-18). Spanton's appeal of this decision to the Equal Employment Opportunity Commission is pending.* TR III, 49(1-12).

Subsequent to filing his EEO complaint and after testifying on behalf of a subordinate auditor Herbert Branch in an appeal before the MSPB, Spanton received a low performance appraisal from Arlin Tueller. TR II, 76; CX 6; CX 43; CX 53; CX 54. Spanton grieved his appraisal, complaining to Evans' deputy Hill and ultimately took his grievance to Brown in a letter dated February 25, 1982. CX 59-62. On March 15, 1982, Brown required Spanton to come to Washington to discuss the problems set out in the letter, even though at the time Spanton told Brown he intended to withdraw the grievance. TR II, 70(19)-72(1); 74(9)-75(2); CX 147, pp 2-3.

During the March 15, 1982 meeting, Brown asserted that Spanton's FAO had poor employee morale, many personnel complaints and high turnover, and he criticized Spanton's interaction with the Special Audit Teams (SAT). Brown told Spanton that he might not be rotated within the Atlanta region because of his EEO complaint.** CX 11; CX 93, p. 3. Brown testified that, after telling Spanton that his testimony at the

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* On January 25, 1984, the EEOC vacated and remanded to DCAA Brown's decision on Spanton's EEO complaint against Evans. The basis for the decision was that Spanton had improperly been denied a hearing. EEOC Decision No. 01831294 (Jan. 25, 1984).

** Spanton was eligible for rotation in March 1983 under the five year rotation policy applicable to Resident Auditors. CX 4, p.10.

Branch's MSPB hearing was upsetting to the region and not supportive of DCAA, he asked when Spanton was due for rotation and suggested that Spanton should be rotated to another region. TR VI, 12(10)-14(3). CX 93, p. 3; CX 100, p. 7. At the point when Brown suggested that Spanton would be rotated out of the Atlanta region, Spanton was shocked and declared that he did not want to leave the Atlanta Region, but he did want Evans and Tueller to stop harassing him. TR II, 89(2-10); TR VI, 13(24)-14(9); CX 93, p. 3; CX 147, p.4. Brown told Spanton at that point that Spanton did not get along with regional officials and that Spanton should give serious consideration to rotating to Philadelphia. TR II, 89(4-6); TR VI, 13-14; CX 93, p. 3.

On April 13, 1982, Spanton replied to Career Management Board Chairman Hill's letter of March 12, 1982, requesting rotation preferences.* CX 11. Spanton referred to his March 15, 1982 meeting with Brown and the proposal made by Brown at that meeting to relocate him to Philadelphia over his objections. CX 11, p. 1 (¶ 2). Spanton wrote that he preferred to rotate within the Atlanta region but that in any event he intended to retire at the latter part of 1983. CX 11, p. 1 (¶ 3, 4). Accordingly, he requested the Career Management Board to extend his tour at West Palm Beach until his planned 1983 retirement. CX 11, p. 1 (¶ 4). The DCAA rotation policy contemplates and permits deferral of rotation upon such a request. The DCAA manual provision then in effect* stated in pertinent part:

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* Hill was then Evans' deputy, having replaced Brookhart. As an additional duty, Hill was Chairman of the Career Management Board.

> Requests for exemption or deferral of rotational reassignments, initiated by the employee concerned or by regional management, will be considered on the following bases:
> . . . (2) . . .
> 3-3d. (12) An announced intention to retire within the year following a proposed rotation PCS move may be grounds for deferring such move with a clear understanding that failure to retire as announced will result in early reassignment.

CX-4, p. 16, 3-4, a; a #2 and see CX-4 page 15, 3-3d(12).

Spanton concluded from the March 15, 1982 meeting that Brown was planning to rotate him out of the Atlanta region in retaliation for his EEO appeal and testimony in the Branch hearing; on March 24, 1982, Spanton told EEO Counselor James Cox about the meeting with Brown. TR II, 90(22)-91(7); CX 96. See also Brown Exh 3 (stipulated).

Meanwhile, Brown sent copies of his notes of the March 15, 1982 meeting to Evans, Tueller and Cali and called them to a meeting at DCAA/HQ on April 2, 1982 for the purpose of discussing Spanton. TR VI, 15(8-17); CX 100, p. 1; CX 147, p. 6. Brown prepared a written summary of their remarks, which they each adopted. CX 100, pp. 9-15; CX 147, p.6. Both Tueller and Evans testified concerning the April 2, 1982 meeting with Brown. Tueller stated that in April 1982 when he was asked to make a recommendation concerning Spanton's waiver of rotation, he officially recommended against waiver. TR X, 148(13-22). Tueller stated that he knew that Spanton was eligible to retire when he made the recommendation. TR X, 98; CX II. Evans testified that on April 2, 1982, after Brown put Spanton's actions "into perspective" for him, he favored Spanton's transfer out of the region. TR XI, 146-148. Evans asserted that nothing occurred later to change his mind. TR XI, 149(10-13).

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* These provisions were carried forward in September 1982 revision, CX 4, p. 34.

Brown's notes of the April 2 meeting reflect that Spanton's testimony at the Branch hearing was discussed; a lengthy quotation from Spanton's MSPB testimony was included in Brown's notes regarding Spanton's alleged non-support of DCAA management.* CX 100, pp. 14-15. Brown's notes also reflect comments by Evans describing Spanton's first attempts to grieve his performance appraisal or to add it to Spanton's EEO complaint against Evans, which Brown had ruled upon in December 1981. CX 45; CX 100, pp. 13 (bottom ¶), 17.

Brown testified that he concluded from the remarks at the April 2 meeting that Spanton had caused misunderstandings in SAT matters and that Spanton was the "protagonist" and "instigator" in these purported problems".* TR VI, 16(19)-17(5), 19(1-2), 76(8-12); CX 149, pp. 4 (¶ 4), 6 (¶ 3).

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* TR VI, 51(9-19). Brown also admitted authorship of his April 2 meeting notes which were reviewed by Cali, Evans and Tueller and attached to Brown's May 11 letter to Spanton. CX 100, pp. 1 (¶ 4), 14, 15. These notes contain an exact quotation from Spanton's Branch testimony. *Compare*, CX 50, p. 24(22)-26(16), *with* CX 100, p. 15. Moreover, these notes reflect that Spanton's Branch testimony was, in the minds of Brown, Evans, Tueller and Cali, evidence of Spanton's conflict with Atlanta regional management. CX 100, pp. 2 (¶ 3), 15.

At the hearing, Brown testified that the sentence in his May 11 letter, "distrust of regional management is further evidenced by your testimony before the MSPB in the Herbert Branch case...," was derived from a different portion of Spanton's testimony from that contained in Brown's April 2 notes. TR VI, 47(15)-49(14); CX 100, p. 15. Despite this claim, Brown was unable after studying the transcript to identify that portion of the transcript. Brown testified, "I don't know where it came from." TR VI, 51(9-17).

Both Brown and Evans have conceded that Spanton was a competent FAO manager and audit technician. TR VI, 19(2-4); CX 6; CX 146, p. 17(9-10); CX 147, pp. 5, 8. *See* footnote p. 7, *supra*. Evans, Tueller, and Cali told Brown on April 2, however, of a number of purported problems with Spanton's management, including employee morale. TR VI, 16; CX 100, pp. 9-15; CX 147, pp. 7, 8; CX 149, p. 5 (¶ 2). In April 1982, however, Tueller had officially reported that staff morale was good, productivity high and relations with regional staff adequate. TR I, 76-77; CX 6, p. 21. Moreover, the regional personnel office had reported in September 1981 that "motivation and cooperativeness" of staff were substantially higher than before. CX 16, p. 24. Brace and Flanagan, audit supervisors who worked for Spanton, both testified that morale in 1982 was good and improving. TR IV, 8(20)-10(5); 31(18-23).

Tueller admitted that in the summer of 1981 morale was improving. TR XI, 10(8-18). That assessment was concurred in by Moyes of the

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* Brown testified at the hearing that, in arriving at his decision to order Spanton to rotate six months ahead of schedule, he "focused" on Cali's remarks at this April 2 meeting and was less concerned with other issues discussed by Evans and Tueller. TR VI, 16(19-23), 46(12-14), 65(17-23). According to Brown's April 2, 1982 notes and his testimony at the hearing, Cali's view was that a series of little things bothered him about Spanton but the specifics "are difficult to pin down." CX 100, p. 9. Further, Cali said, "all of these small things in and of themselves don't mean much." CX 100, p. 11; CX 147, p.7. Both Evans and Tueller later swore to OSC investigators that they had advised Brown that a delay in Spanton's rotation out of the region until January 1983, would have presented no management problems. TR VI, 83, 84(1-5); CX 146, p. 112(10-23); CX 158, p. 93(4-24).

AFPRO and was reflected in Spanton's 1981 mid-year evaluation which was given to Spanton in April 1982. TR II, 11(2-6). Similarly, Evans admitted that there was continuing improvement in personnel matters: a decline in sick leave usage; low turnover within the FAO; and a decrease in the number of complaints filed from 1980 forward. Evans also conceded that no grievances had been filed by subordinates of Spanton since 1981. TR XI, 134(17-25).

In April 1982, Brown decided to rotate Spanton before the March 1983 expiration of his five year rotation period. TR VI, 13(1), 19(22)-20(4). Brown wrote to Spanton informing him of his decision on May 11, 1982. CX 100; CX 149, p. 2. On being advised by Brown of this decision, both Evans and Tueller concurred. CX 146, pp. 110, 111(1-3); CX 149, p. 7; CX 158, pp. 73(18-24), 74(1-7), 79(18-19). Brown included as an attachment to this letter the notes of his meeting with Evans, Cali and Tueller on April 2, 1982. CX 100, pp. 9-15.

On June 3, 1982, Tueller, on orders from Brown, made Spanton an offer of rotation to Newport Beach, California as Resident Auditor of the Ford Aerospace office. CX 101.

On June 10, 1982, Spanton wrote to Brown and reluctantly accepted the offered position in Newport Beach, California, while expressing his continued disagreement with Brown's stated reasons for the rotation out of the Atlanta Region. TR II, 100(12)-101(16); CX 102. He asked Brown to extend the relocation date to January 1983 instead of September 15, 1982, because of "family and medical commitments." CX 102. At the same time, Spanton also asked Brown to provide him a legal determination of his responsibility to repay to the government moving costs for him, his family and household goods across the country from West Palm Beach, Florida to Newport Beach, California, if he should retire after less than a year at his new post. CX 102. Spanton noted that the relocation would be involuntary on his part and asked that this fact be considered in the legal determination. *Id*. On June 18, 1982, the General Counsel of DCAA responded to Spanton's request by saying there could be no definite answer as to Spanton's legal obligation to reimburse the government for moving costs if he retired less than a year after the event had occurred. TR II, 101(17)-102(5). CX 103.

On June 21, Brown wrote to Spanton and declined to accommodate Spanton's request for a delay in rotation from September 15, 1982 to January 1983. CX 105. On July 7, 1982 Spanton wrote to Brown and asked him to reconsider the early rotation order and provided his analysis of the reasons which Brown had assigned for his order. CX 106. On July 13, 1982, Spanton again requested the General Counsel to inform him of his legal obligation to repay moving costs based on the hypothesis that he would be relocated in September 1982, as ordered by Brown on June 21, and would retire December 31, 1982. CX 104. The General Counsel again declined to give any advice to Spanton as to what his legal and financial obligations would be under those circumstances. TR II, 102(6-21). On July 14, Spanton again wrote to Brown, protested the September 12, 1982 relocation date, and offered to consider sites other than Newport Beach, if the Newport Beach situation required a move before December 1982. CX 107. Spanton advised Brown that, if the delay until January 1983 were not possible, he would retire under protest on December 31, 1982. TR II, 105(7-11). CX 107.

On July 29, Brown again denied Spanton's request, after considering the two letters Spanton had sent. CX 106; CX 107; CX 108. Brown cited "an environment of conflict" with regional management. CX 108 (¶ 2). Brown was aware that regional management did not oppose the delay. TR VI, 83(4)-84(2). Brown nevertheless said that a delay from September 15, 1982 until January 1983 would "unduly delay a move I believe to be necessary to rectify the situation which now exists at your current location" and refused to delay the rotation order. CX 108 (¶ 3) and (¶ 4).

Brown viewed the early rotation of Spanton which he had ordered on May 11, 1982, and reaffirmed on June 21 and July 29, 1982, as a penalty to be imposed on Spanton - "If I had investigated Spanton's allegations or claims and found them meritorious or that he was correct, would I have made the same decision to rotate him out of the region early? *Why would I penalize him or any other employee for being correct*?" (emphasis added)* TR VI, 70(13)-71(15); CX 149, p.8. See e.g. CX 100; CX 105; CX 108. Brown knew that Spanton believed that Evans and Tueller were harassing him because of his refusal to retire. TR VI, 14(8-9), 74(9-16), 76(1)-77(10); CX 147, p. 15. Brown admitted, moreover, "the truth [as to Spanton's complaint of harassment] lay somewhere in the middle." TR VI, 77(13-21); CX 147, p. 14 (top).

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* Brown intended to use the word *penalize*, for he personally corrected the spelling of this word when he signed this statement. CX 149, p. 8 (*note* initials).

In early August, 1982, Spanton's labor rate report became a subject of media attention and Spanton began to be quoted in articles in the press. CX 121, pp. 1, 5, 6, 9, 10.

In late August 1982, after Spanton's disclosures came to the attention of Secretary of Defense Weinberger, Brown's order for Spanton's September 1982 rotation was cancelled by order of the Secretary. CX 121, p. 12. On August 27, 1982 Brown rescinded his rotation order to Spanton. CX 109. Spanton could thus remain at West Palm Beach at least until his normal rotation date in March, 1983.

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Senator **Levin**. May I ask one additional question, Mr. O'Connor and Mr. Chairman?

Perhaps you may have covered it and I may have missed this. After your investigation is complete, will you be able to supply to Mr. Sherick and this committee the names of auditors who have told you that they were told by their supervisors not to unnecessarily ruffle feathers in companies that they are auditing?

Mr. **O'Connor**. I would be happy to provide all the information in my files to Mr. Sherick, and have done so.

Senator **Levin**. Then could we ask Mr. Sherick, who is sitting here, whether he can give the committee a report on those kinds of directives coming down to auditors not to unnecessarily ruffle feathers of companies that they are auditing?

Mr. **Sherick**. One of the oversight studies that I have is entitled "Independence," and that is certainly part of it.

Senator **Levin**. Thank you.

Chairman **Roth**. Thank you, Mr. O'Connor.

Mr. **O'Connor**. Thank you, sir.

[A letter from Mr. Sherick follows:]

Department of Defense,
Inspector General,
Washington, D.C., April 11, 1984.

Hon. William V. Roth, Jr.,
Chairman, Committee on Governmental Affairs,
U.S. Senate, Washington, D.C.

Dear Mr. Chairman: At the recent hearings on the Defense Contract Audit Agency (DCAA), Senator Levin requested that I provide the Committee with certain information from investigative files provided to me by the Special Counsel, Merit Systems Protection Board. Specifically, Senator Levin requested information from the investigative files dealing with guidance that directed DCAA field auditors not to "unnecessarily ruffle feathers of companies they are auditing."

We have completed our review of the subject investigative files. We found no evidence in these files of written guidance from either DCAA Headquarters or regional offices that instructed auditors to avoid confrontations with contractors. The files did contain, however, statements by two DCAA auditors that they were instructed by regional supervisory personnel not to force the resolution of certain issues with three contractors.

In September 1983, I advised you of our plans to perform an oversight review on the relationships between DCAA and contractors and DoD procurement officials. That review is now underway. The overall objective of this review will be to determine if DCAA auditors maintain an independent attitude and appearance in their dealings with contractors and DoD procurement officials to ensure that appropriate auditing standards are complied with in the performance of their audit work. If you so desire, I will provide your Committee with a copy of the final report on this review. We estimate that the final report will be issued by September 1984.

Sincerely,

Joseph H. Sherick,
Inspector General.

Chairman **Roth**. Our final panel is Mr. George Spanton, a DCAA resident auditor, retired, of West Palm Beach; Mr. Murphy, who is also retired, a former DCAA supervisory auditor, and finally, Mr. John Batson, a criminal investigator for the Office of the Assistant Inspector General for Investigations.

Senator **Levin**. We ought to have a chair for Mr. Fitzgerald this morning.

Chairman **Roth**. The suggestion has been made that maybe we ought to have an empty chair for Mr. Fitzgerald. That would be appropriate.

Senator **Levin**. Gone but not forgotten.

Chairman ROTH. Mr. Spanton, I understand you have a prepared statement. We will ask you to begin the panel.

TESTIMONY OF GEORGE R. SPANTON, DCAA RESIDENT AUDITOR (RETIRED), WEST PALM BEACH, FLA., ACCOMPANIED BY WOODROW W. MURPHY, DCAA SUPERVISORY AUDITOR (RETIRED), DALLAS, TEX.; AND JOHN BATSON, CRIMINAL INVESTIGATOR, OFFICE OF THE DOD ASSISTANT INSPECTOR GENERAL FOR INVESTIGATIONS

Mr. SPANTON. Mr. Chairman and members of the committee, I appreciate this opportunity to appear before the committee. I believe my experience with the DCAA, particularly within the past 3 years, will provide you with information that will be useful to you in taking constructive action to improve the agency's audit performance. I can assure you that committee action is necessary for the good of the Government and the taxpayer.

The role of the DCAA has been characterized as being that of "a watchdog of the defense dollar." Unfortunately, the DCAA has been anything but aggressive in performing its role, and its very existence may be creating a false sense of security among those within and outside the Government who are concerned about our tax dollars and the budget deficits and rely on agency auditors to protect the taxpayers' investment in our national defense.

Attempts to disclose waste and abuse of tax dollars by major defense contractors are met with hostility and rejection by the agency. Not only was my work ignored, but I was continually threatened and harrassed. In addition to forced transfers and pressure to retire, I was subjected to criminal investigation for not being soft on the contractors.

The contractor himself had me investigated by the Justice Department. My performance ratings went down and down, and the agency deprived me of earned annual leave.

I was forced to become a whistleblower in order to bring these conditions to the attention of individuals in positions to do something about them. This, in turn, subjected me to pressure and crank calls which at times made me wonder if it was all worth it. Let me assure you, though, that it was, because the Government and the taxpayer must be told how these present conditions continue to cause excessive waste in the Department of Defense.

Let me give you an example of why the Agency wanted me out. I issued an audit report questioning the pay escalations for a major contractor. The report showed that raises to company employees were twice as high as those granted workers in the private sector; triple that of Federal employees. This is creating an ever-widening gap between those working for defense contractors and those in the private sector, and the fact that it created a competition problem for employees between the private sector and defense contractors, financed by the Government.

We estimated that proposed raises at this one location would cost the Government an unnecessary $150 million in a 3-year period from 1982 to 1984. I notified the DCAA that potential cost savings throughout the defense industry would be billions of dollars.

The DCAA did nothing on the labor rate situation. The DCAA management's actions regarding the labor rate report illustrate the state of the current atmosphere in procurement, wherein defense contractors virtually dictate the terms of negotiation. What major defense contractors ask for usually establishes a baseline for negotiations, because the Government communicates the attitude of not wanting to make negotiations too difficult and operates under the assumption that the contractor will not accept auditors' positions. The contractor controls the negotiation.

If the DCAA had been doing its job, would the Department of Defense have the embarrassment of answering and reading stories on waste on spare parts? I do not believe so.

The Agency has too close a relationship with the defense acquisition community identified by the DCAA as its client when the real client should be the Government and the taxpayers.

The Agency even tries to have relationships with defense contractors by being careful to assure that their auditors are not too tough; that the auditors are reasonable. A compromise is a solution to audit difficulties, and the DCAA theme is work around the problem.

One of my allegations as a whistle blower was access problems were investigated by the agency and rejected by the DCAA as untrue and nonexistent and was used to force my transfer.

In fact, one of the contractors in 1982, in my letter of 1982 in which I claimed contractors did not provide auditors with records, was Texas Instruments. That letter was sent to Mr. Starrett.

The Agency, despite protests, had problems, and their protests continue to exist from throughout the field. They continue to deny it. Most often, it explains the problem away by showing an understanding of the contractor's reasons why they cannot or won't release information to the auditors. Resultant audits in these situations are essentially worthless, in fact, have never been performed.

Access problems include extensive delays by contractors in furnishing audit requested dated. Contractors are aware that auditors are working to meet deadlines and intentionally delay the support, thereby minimizing the auditors' effectiveness, quality and productivity.

The Agency does have tools to force the issue of nonaccess. One of these is a Form 1 Notice of Costs Suspended, a very effective tool, but the agency is reluctant to use it because it is upsetting to its procurements and, of course, the contractors.

An interesting statistic would be the number of form 1's issued by the DCAA in the past 3 years to resolve access issues on major contractors.

You can probably count them on one hand with a few fingers left over.

As Mr. Starrett said, my office was one of them. Just a few weeks ago, Mr. Starrett, in sworn testimony before the Merit Systems Protection Board, said that he didn't consider access to records a problem in DCAA.

The problem of permitting the contractor, the contractor's public accountants, to perform audits before the DCAA in the areas that the contractor considered sensitive areas, is a totally unacceptable practice.

In fact, he agreed there are conditions where contractors have a right to refuse to permit auditors to audit certain accounts because the contractor considers them sensitive.

The most recent example of a problem is that of General Dynamics in Fort Worth, Tex.

I had recently learned that the resident auditor at that location, within the last couple of days, announced his resignation because the DCAA regional and headquarters officials were not supporting him in his efforts to gain access to the contractor's accounting records.

He described his job at General Dynamics as extremely frustrating under these circumstances.

As far as reorganization in DCAA is concerned, at the minimum the DCAA should be transferred from the jurisdiction of the Assistant Secretary of Defense (Comptroller) to the Department of Defense Inspector General.

Such a move may serve to establish some degree of independence and to solve the unhealthy relationship that presently exists between DCAA and its clients—the defense community.

Ideally, the DCAA should be combined with other internal audit agencies into a new organization. Various auditors have disclosed significant waste which goes uncorrected within the military because the audit agency is not independent of the DOD.

I thank you.

Chairman ROTH. Mr. Murphy, would you proceed?

Mr. MURPHY. Yes, sir.

Thank you.

Mr. Chairman and members of the committee, I am Woodrow Murphy, formerly a GS-13 supervisory auditor with the Defense Contract Audit Agency before I retired on December 31, 1982, with 33 years of experience.

I am a graduate of Southern Methodist University and have a bachelor's degree in accounting. I began my civil service career with the U.S. General Accounting Office where I participated in audits of both Government agencies and defense contractors.

During the period of my employment with the Department of Defense, first with the Navy audit, I directed increasingly complex audits and was promoted to supervisory status.

The subject of this hearing, management, and operations of the Defense Contract Audit Agency, has been of special interest to me for many years, and I fully support this committee's objective to find ways to improve the effectiveness of this agency.

I hope my testimony will help achieve that objective.

As an auditor with GAO, I audited defense contracts at several aircraft plants in the vicinity of Dallas, Tex., and at the atomic energy plant in Amarillo.

My work experience with the Defense Contract Audit Agency can be summarized as follows:

I spent a total of about 10 years as resident auditor at Bell Helicopter, Collins Radio Co., and Chance Vought Corp. in Texas, and at the Hughes Aircraft Plant in Fullerton, Calif.

I also served as regional and then branch office supervisor for about 11 years.

My next assignment, the one I will discuss in more detail today, was a 3-year assignment as supervisory auditor at Texas Instruments in Dallas, Tex. In my last assignment before my retirement, I was a supervisory auditor at the agency's Richardson branch office.

My experience included many diverse and very complex audits at several defense contractors. Let me mention a couple of them. I audited the claims or equitable price adjustments of approximately $156 million by Avondale Shipyards in New Orleans, La. The Navy's claim settlement team committee was headed by Mr. Gordon Rule and Admiral Ken Woodfin.

In connection with a Baifield Industries' $15 million claim for equitable contract price adjustments, I performed an audit and presented related testimony which resulted in an ASBCA decision to award the contractor only $137,000. In total, I issued eight reports that resulted in ASBCA cases, and I testified before the Board on five of these cases.

As a general rule, contract auditors can persuade small defense contractors to provide unrestricted access to facilities, records, and related data needed to perform the audit mission, including but not limited to, labor attendance and time checks; classification, control, and utilization of Government-furnished special tools and test equipment; and examination of recorded and expected costs.

I am personally aware that as early as 1958, Texas Instruments [TI] was a most difficult contractor to obtain the records and data required to accomplish the contract audit mission.

In commenting on an audit report in 1965, the contractor acknowledged to the Navy that "time after time throughout this report, it is mentioned that we did not give the auditor access to cost data on fixed price contracts. This statement is true."

At TI, I encountered many long delays before I received responses to my requests for accounting records; and in my judgment, long delays mean denial of access. At TI, I was denied access to both property and incurred cost records.

The situation was so bad that in 1979, one of DCAA's regional audit managers wanted to issue a disclaimer against TI. At the conclusion of an estimating system audit which I conducted, one Atlanta regional audit manager wanted to issue an inadequacy report. However, as far as I know, it was not issued.

In order to resolve the problem created by the inadequacies in the contractor's submissions, I notified the contractor in writing so that he would have an accurate understanding of the nature and extent of the inadequacies of the records and data that he submitted with his proposals. With the concurrence of the resident auditor, a copy of each of the letters I drafted was sent to the procuring contracting officer pursuant to the requirements in the Defense Acquisition Regulations.

In response to my letters, the contractor told me that if I didn't stop sending copies of my letters to the contracting officer, he would get me transferred. He later carried out his threat.

Toward the end of my duty at TI, the access to records problem still wasn't resolved, even though TI had promised to allow more access to records. At the conclusion of one meeting to obtain greater access to records, the resident auditor said that he had been promised access many times before and expressed the opinion that he was skeptical whether TI would comply.

We even had trouble gaining access to the production lines in Government-owned facilities, and let me add here, this relates also to cost-type contracts. Based on a preliminary study of Government property, I suspected that the Defense Department might be wasting millions of dollars at TI by providing funds for special tools and test equipment.

In one case for example, the M-1 tank thermal sight, the Government provided TI over $5 million for special tools and test equipment. Like me, some Defense Contract Administration Service Office personnel at TI were also concerned that TI had purchased standard, off-the-shelf industrial tools and test equipment and had classified and was paid for them as special tools and equipment.

In this case, DCAA could have issued a notice of cost exception suspending or questioning these costs. Instead, the regional auditing manager closed out the study on the premise that we did not have the expertise to make such a determination.

To my knowledge, the restrictions on DCAA's record access to TI records has existed for over 25 years. As a result, the scope of many audits at TI were limited. auditors' conclusions had to be qualified, and audit recommendations were incomplete and less helpful to the Government procurement and contract administration personnel.

The ultimate impact of Texas Instruments' denial of access to records and facilities was to place the Government's contracting officers in a very unfavorable bargaining position when negotiating prices on many of the sole source contracts negotiated with Texas Instruments.

I understand that as a result of the recent attention drawn to the access to records problem by your committee investigators, DCAA officials met with the TI comptroller and resident Government contract administrator in December 1983 to resolve the longstanding access to records problem at TI.

However, just last week I learned that the investigators found that as recently as January 1984, Government officials at Texas Instruments were still apologizing to procurement contracting officer personnel for providing extremely limited cost analysis in support of contract negotiations.

The reason, as usual, was restrictions in access to the records that supported TI's pricing proposals.

Due largely to my persistent efforts at TI to gain access to records and production facilities to conduct my audit work, I eventually found myself in the same position as Mr. Spanton. The contractor had complained to DCAA officials, and as a result, I was given three options: permanent change of duty station, retirement, or dismissal.

During my assignment at TI, I suffered my first serious coronary sickness, and in the recovery process, I had to use some of the 2,000 plus hours of sick leave that I had accumulated over a long period of years with the Government.

After I was transferred from TI residency to the Richardson branch office, I, again, suffered severe coronary problems. The Atlanta region felt that I was cheating on the system and ordered me to take a physical fitness for duty examination.

In January 1981, I had a pacemaker implant. Incidentally, the physical examination cost the Defense Contract Audit Agency over $2,000. I saw that the continued administrative pressure, coupled with the constant adversarial nature of the job, was taking a toll on my health.

At the insistence of my son, who is a medical doctor, and my family doctor, I chose one of the three options offered by DCAA. I retired.

Before closing, I would like to mention three personnel management practices in the Defense Contract Audit Agency that I found particularly harmful:

(*a*) The use of the Bell curve by the Atlanta region to rate supervisory personnel was one of the most demoralizing and grossly unjust practices I witnessed in my over 30 years of experience with the Government. The requirement to achieve a symmetrical distribution of performance ratings precluded a realistic rating of each auditor. I have reason to believe that this practice continues.

(*b*) The practice of arbitrarily rotating auditors every 5 years was unnecessary and costly to the Government in terms of both money and experience and reduced efficiency. This is particularly true for auditors who are approaching retirement such as Mr. Spanton and I were.

(*c*) Incentive performance pay should not be based on agencywide man-hour standards. You cannot legitimately evaluate an auditor's performance at one location where there is an access to records problem on the same basis as you can evaluate an auditor's performance on a similar assignment where access to records is not a problem.

In conclusion, I believe the efficiency of the Defense Contract Audit Agency can be enhanced by the following changes in practices.

One, stop the practice of taking auditors off assignments because of contractor complaints unless it can be demonstrated that the auditors' practice is or has been unprofessional.

Two, insist that Defense Department procurement officers assure that the contractor's pricing proposals and other submissions are complete and adequately supported and that DCAA auditors are granted the necessary access to contractor's records and facilities.

Three, assure the contract auditor's organizational and personal independence by making the Defense Contract Audit Agency a part of the DOD Inspector General's Office.

Four, increase the amount of effort applied to audits of Government property in the possession of the contractors. Audits of Government furnished property currently receive a very low priority in DCAA.

Mr. Chairman, this concludes my prepared statement. I will be pleased to answer any questions you wish to ask me.

Chairman ROTH. I understand that Mr. Batson has no prepared statement; is that correct?

Mr. BATSON. That is correct, Mr. Chairman.

Chairman ROTH. But he is available for questions.

First of all, let me thank each and every one of you for being here today. One of my concerns is that the so-called whistle blower—and I want to be very fair about the fact that it is not only true of this administration, but its predecessors as well—is never supported by the administration then in office.

I don't know whether that is because it comes down from on high or whether it is part of a bureaucracy in the Pentagon that doesn't change from year to year.

One of my concerns is that we are told, "Well, these are the whistle blowers," that there are just a few of them. They are usually people who are dissatisfied for some reason and are trying to create problems.

We are not here to go over your case which is being tried, Mr. Spanton, and I notice in your testimony that you avoided any discussion of that.

I must say I think the litigation will be interesting to watch in the future.

But one of my concerns is that it doesn't take very many cases to sort of put a damper, a cold chill on auditors or anyone else, and keep them from doing their job.

But why is it that down through the years, and this is true with both Democratic and Republican administrations, there seems to be a chill put on the so-called whistle blower.

Is that something inherent in the organization, or what?

Mr. Spanton, would you care to comment?

Mr. SPANTON. It is simply a question of fear, the need for a paycheck, and the concern of how the message that the employee has will be delivered.

During my period of whistle blowing, I had numerous phone calls from individuals within the Agency, within the Defense Contract Audit Agency, and these people had problems very similar to my own, for example, access problems.

I told them I felt that it was a responsibility for them to speak up, or at least to overtly. They wouldn't do it. They said, "I just want you to know that I am in bed with you, but not publicly."

This is a situation that I think I heard more of in the last 1½ years than in previous years, the fact that people that encouraged me, once I stepped forward, to pass on their problems, but they wanted them done anonymously, and it was out of fear.

They know that their messages will result in rotations. I know of individuals on rotation programs that said they would speak out but said they were afraid that they would be moved to some distant location, and so this has a stone.

Chairman ROTH. Do you care to comment, Mr. Murphy?

Mr. MURPHY. Yes, sir, I definitely know that other auditors would have been willing to appear before this committee, even though on a limited basis; but they feared retaliation by the Agency, so they declined to do so. Some specifically told me that.

Other auditors I know have said to me since I was removed from Texas Instruments, "I am not going to push. I know what happened to you."

Chairman ROTH. Would you say the refusal to permit Mr. Fitzgerald to officially appear has a chilling effect on those that want to cooperate with this committee?

Mr. MURPHY. Well, sure; I think so. Yes, sir, I think so.

Chairman ROTH. You mentioned—excuse me.

Mr. MURPHY. I was going to give you a specific example, but I guess I had better not mention that specific instance.

Chairman ROTH. I believe, Mr. Spanton, that you mentioned Patrick Sanchez?

Mr. SPANTON. Yes.

Chairman ROTH. Would you spell out exactly what his position was? Was he in a supervisory position? How many people did he have report to him, and again, what was the reason for his resignation?

Mr. SPANTON. His position was similar to my own. He is a newly assigned resident auditor. I believe he has a staff of roughly 40, and in talking to one of my friends from Texas yesterday, I learned that he just couldn't put up with the conditions that he faced, for he had a strong responsibility to represent the Government, and he couldn't fulfill his responsibility because the contractor would not provide the records to do the job.

DCAA was of no help in resolving the problem. He felt that it was too much of a burden for him to take on.

Chairman ROTH. We just learned about this last night. The committee will be very interested in having the opportunity of discussing the matter with Mr. Sanchez.

If you are in contact with him, I wish you would so advise him.

I would like to go back to the basic issue because what we are talking about is access to information, to reports, to data in order to enable the contracting officer to negotiate effectively.

It is my understanding there are a lot of so-called qualified reports. Have the contracting officers ever complained about the fact they are not getting adequate information and suggested that the contrasting officer should not proceed?

What has been their attitude?

Mr. SPANTON. Senator, the contracting officers prefer, in many cases, the contractors certainly preserve it. The contractors find it is much easier to negotiate an area that would otherwise be questioned to having it qualified. In fact, one of the major areas that the agency qualifies costs is in the proposed cost area on price proposals, which Mr. Starrett says the bulk of the agency's time is spent.

In these situations, contractors, in many cases will not provide support to the auditor for, let's say, proposed costs of materials. They will give estimates. I had followed the practice in those cases to tell the contractor, "it is your proposal. If you are not going to support it, we are going to question the costs."

After doing this for several years, I was directed, with strong direction, no questions about intent, to cease that practice and come up with some reasonable estimate of what I thought the contractor should be allowed.

The contractor enjoys this situation. He finds it very easy to manipulate contracting officers when he says, "here is an auditor without any basis that comes up with a figure. What makes you think his figure is any better than mine?"

And he proceeds from there.

The situations can be handled throughout the agency very simply. Let's get tough as Senator Levin suggested, and that is, we do have control over the dollar. The simplest message to the contractor is, "We are not going to pay you." The vehicle to accomplish this is the form 1 cost suspension. In my entire career as an auditor over three agencies, I rarely—did not have a single situation where I was unable to resolve an access to records problem. But I did it with the use of the form 1, getting tough. And that is the answer. Otherwise, no matter what tools you come up with, if you don't implement them, they are worthless.

Chairman ROTH. So what you are saying in a sense is the tools are already available if they would utilize them?

Mr. SPANTON. The tools are there. As I say, I never encountered an access to records problem that I could not resolve, and I had a large operation working out of West Palm Beach, Fla., of well over 100 contractors and not a single access problem. And I resolved an access problem, executive compensation records of Pratt & Whitney, and Pratt & Whitney was willing to give the lower level records on earnings of their employees to me, but not the executives. When I insisted on it, they just simply refused, and with the simple action of issuing a form 1, within 30 days we got all the records we wanted.

May I add one more point. That the comptroller of Pratt & Whitney informed me that he had many discussions with major contractors throughout the Northeast, that is, the comptroller of United Aircraft, and they have similar problems. They just don't give the records to the auditors, very simply, and they don't have problems. That is what concerned him, that I was pushing that hard when others didn't provide the records and didn't—and they got away with it.

Chairman ROTH. Are you aware of any time in recent years where anyone was rewarded for being a tough auditor?

Mr. SPANTON. I can only give you my own experience. My rating went down from the top one-third to rock bottom.

Chairman ROTH. Let me just ask you this, because we are talking about access to records. Are we talking about major kinds of information, the general ledger?

Mr. SPANTON. Yes, sir.

Chairman ROTH. The basic labor costs, pay for executives, white collar workers? What kind of information were you having difficulty gaining access to?

Mr. SPANTON. The most important single record is the general ledger, and without the general ledger, the auditor's ability to validate any other cost record doesn't exist. That one single record, obtaining that record, a complete general ledger, trial balance through the agency is a rarity. Now, the contractors say, "here are the 10 accounts, for example, that we consider sensitive to us, and we don't want to tell you what's in there." In fact, if the contractor had just one account where he could conceal, let's say, rebates from suppliers, whatever the content of the transactions were of that account, it could hurt the Government, it could create unnecessary costs, it can create waste. Yet the agency follows a philosophy, the contractor is entitled to certain privacy, certain proprietary information. As far as I'm concerned, when the Government has major contracts with these defense contractors, we should see everything. We have a right to know. We must know or these successes are going to stop them.

Chairman ROTH. I do want to set the record straight that what we are investigating today is the management of DCAA. We are not trying to pry or investigate any particular contractor, nor are we at this stage passing judgment. Because if we do so, we want to make a fairly exhaustive investigation, and of course, we would want to give any party that was involved the opportunity to appear and make whatever statement they might wish. So the thing we are really trying to address right now is the adequacy or inadequacy of the DCAA from a management standpoint.

I see my time on the first round is up. I will turn to Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman.

Again, let me commend you for your persistence in this critical area. It is really a favor to every taxpayer in the country as well as those who believe in a strong defense and know we can't afford to waste defense dollars.

Mr. Spanton, you made reference to form 1.

Mr. SPANTON. Yes.

Senator LEVIN. Form 1 is a stop payment form, isn't it?

Mr. SPANTON. That is correct.

Senator LEVIN. The first and foremost weapon we have got to get information is form 1?

Mr. SPANTON. Yes.

Senator LEVIN. Just quit paying them until they give us the information that we are entitled to.

Mr. SPANTON. That is right.

Senator LEVIN. This is a pretty powerful weapon. You have used it, you say, successfully. Why don't more auditors use it?

Mr. SPANTON. It is upsetting. It creates an air of, let's say, antagonism, really. If you are taking the contractor's money away from him, he is going to turn business on the Agency. This happens. Friendship, company relations disappear. The Agency doesn't want to risk that.

Senator LEVIN. Does the agency discourage the use of form 1?

Mr. SPANTON. Yes.

Senator LEVIN. How?

Mr. SPANTON. By working around the problem. "Why don't you figure another way to solve the problem?" This is the advice. "Why don't you figure another way to solve the problem without pushing that issue?" Why don't you concentrate in that area? "Isn't there some other way to do what you want to do without pushing this issue?"

That is the advice that is given. And it doesn't take too long to condition auditors to know what the philosophy is, and they carry out the philosophy.

Senator LEVIN. Are these directives normally done informally?

Mr. SPANTON. Generally, it is done informally, but I'm sure in some cases it is done through trip reports or other memorandum.

Senator LEVIN. Assuming you have the information, you finally get the unqualified audit, then you can send a record along to the contracting officer. Sometimes, apparently, you have to qualify the auditor, is that right? Apparently some auditors don't use form 1, or for one, don't get the information and send along a qualified audit to the contracting officer. How big a problem is it, in your experience where contracting officers are not following the recommendations of the auditor?

Mr. SPANTON. It's a big problem. The DCAA has a high batting average in contracting officers following DCAA recommendations when the—there is a very narrow difference between what the contractor might ask for and what the DCAA recommends. However, as the differences get greater, then the contracting officers begin to raise questions of the DCAA, and the message that they give is that—"You're not giving us a report. You're not giving us recommendations that we can negotiate." In other words, they're saying, "Make it easier for us to do our job."

Senator LEVIN. Let me get into the rating system which is used by the DCAA. As I understand it, the method of rating is to compare the number of dollars that you have questioned with the number of dollars that you recovered. Is that one of the ways of rating the auditors?

Mr. SPANTON. No. I think that the way—it is not that obvious. I think that the ratings relate to how well you got along with contractors, how well you got along with the contracting officer, how well you got along with the region or with the Agency. That is the primary consideration. I think the quality of the audit and the effectiveness of the audit are far apart in this rating system.

Senator LEVIN. In other words, the better you get along with the contractor, the higher your rating?

Mr. SPANTON. I believe so, yes, sir.

Senator LEVIN. So if you are a junkyard dog and tough and mean, you are saying your ratings go down.

Mr. SPANTON. That was my experience.

Senator LEVIN. Don't they also rate you on the number of dollars you recovered compared to the number of dollars you requested?

Mr. SPANTON. The agency puts out monthly statistics or quarterly statistics to gauge the effectiveness of the auditor by showing how much they question, particularly in the proposal area, how much they questioned and how much they—of these questions were sustained.

Senator LEVIN. So that the greater number you question, the lower your batting average may be. In other words, if you question $100 million and only collected $10 million, you are going to have a worse batting average than if you questioned $50 million and get $7½ million?

Mr. SPANTON. Yes. In fact, that issue was raised, as I said earlier, because we were in a tough audit office, we questioned much more than the average office.

Senator LEVIN. So you run a risk when you do too much questioning?

Mr. SPANTON. That's right, because the amounts that will be sustained as a result of questioning, percentagewise, may run less, percentagewise. That is rough, but the dollars will be greater, and that is ignored.

Senator LEVIN. Is that rating in part based on your percentage average?

Mr. **Spanton**. Certainly.

Senator **Levin**. Which is a discouragement to raising questions?

Mr. **Spanton**. Yes. The simplest thing to do is to question only those things that you are absolutely sure will be negotiated.

Senator **Levin**. Kind of skim it.

Mr. **Spanton**. That's it.

Senator **Levin**. Just take the juicy ones, don't take the tough ones or the ones where we don't have information.

Mr. **Spanton**. That is true, Senator.

Senator **Levin**. I have a couple of questions of Mr. Murphy. In your testimony, Mr. Murphy, you indicated that you sent some of these letters out to the contracting officer saying that you didn't have adequate information, raising real issues with the material that you were given. If I remember your testimony and read it correctly, you indicated that, "the contractor told me that if I didn't stop sending copies of letters to the contracting officer, he would get me transferred. He later carried out this threat."

Are you saying that a contractor, a company threatened to get you transferred and succeeded?

Mr. **Murphy**. He did succeed in getting me transferred.

Senator **Levin**. What company was that?

Mr. **Murphy**. Texas Instruments. May I add a little something to Mr. Spanton's comments? The form 1—and I'm sure Mr. Spanton forgot to mention this—the form 1 is used to question recorded cost. It is not used to question projected or estimated costs. Now, the majority of the qualified audits, of course, relate to evaluation of contractors' proposals. That is why I wrote these letters, because at Texas Instruments I was primarily responsible for auditing pricing proposals. And every contractor proposal that came in was very deficient. Of course the ACO, pursuant to the DAR, has the responsibility to make sure that the proposal is complete. Furthermore, the DAR provides that if the data you receive is not complete, current, and accurate, you should immediately notify the contracting officer, that is the procuring contracting officer, so he can take action against the contractor to get you the data you need so you can submit an audit report without qualifications.

After having written all of these letters—and when I say all of these letters, that is what I mean. I would expect that they would stack up to 2½ feet tall over the 3 years I was there. I wrote a letter over every contractor's proposal that I got. As a result, the Navy finally got upset, and they had an ad hoc meeting or a meeting at DCAA headquarters with the contractor and DCAA personnel. They went back out to Texas Instruments there for an ad hoc meeting. I was telling one of your investigators, Mr. Chairman, that it is quite ironic. At one of the meetings I had with one of the TI officials, we asked him how he estimated the direct labor hours, and he said, "I took it—sometimes take the last three digits of the RFQ, I square it and divide it by two." This is a matter that is documented in DCAA files, because another auditor was there with me. We witnessed it, and we both signed the memo. So estimates are a problem.

Senator **Levin**. Thank you. Just one question for Mr. Batson. What was the reaction within your own office when you returned from investigating the Spanton matter with the conclusion that the problem wasn't with Mr. Spanton but with his supervisors?

Mr. **Batson**. The reaction I got concerning my conclusions and reports I wrote up was that we should pursue the allegations which surfaced from the Spanton investigation by opening a new investigation and gathering sufficient evidence or as much as we could and then, of course, having discussions with assistant U.S. attorneys and other law enforcement bodies.

Senator **Levin**. Does all that mean that you met resistance when you shared those conclusions?

Mr. **Batson**. No. I don't think in the Defense Criminal Investigative Service that there was any resistance.

Senator **Levin**. From your supervisors? What was their reaction again, because I'm not sure I understood it?

Mr. **Batson**. I basically was instructed, after concluding the Spanton investigation, to open a case and conduct an investigation as a result of allegations that I had received by Mr. Spanton against the contractor.

Senator **Levin**. Against the contractor?

Mr. **Batson**. Yes, sir.

Senator **Levin**. You didn't meet any problem with the supervisors. They accepted those conclusions?

Mr. **Batson**. Yes, sir, they did accept those conclusions.

Senator **Levin**. My time is up. Thank you, Mr. Chairman.

Chairman **Roth**. Mr. Batson, I understand that you have a bachelor of science degree with a major in finance and accounting. You are a CPA, and your Government experience has been primarily in the Treasury Department serving as a special agent in the Criminal Division and as an auditing manager in the Audit Division. Would you care to make any comments about the code of ethics for Defense Department employees compared to those in the Treasury specifically relating to acceptance of gratuities and employment opportunities?

Mr. **Batson**. Mr. Chairman, my experience in the Treasury Department as a special agent and as an audit manager included almost monthly reminders in some form or another about the Government employees' responsibility to avoid conflicts and other problems which might give the appearance of a lack of integrity. In my opinion, based on what I know so far after 2 years of experience with the Department of Defense, there is a severe integrity problem in the procurement area, perhaps it is not as severe on an individual basis as it is when you look at how extensive it is in viewing gratuities and other appearances of conflict of interest. It should not be tolerated, in my opinion.

Chairman **Roth**. Let me go to a different area.

As an investigator, could you describe what you found regarding DCAA taking action on reports of criminal violations by contractors? I think those are what they call 12–701 reports, and could you also comment on the conclusions which you drew regarding the way management handled these reports.

Mr. **Batson**. At the time, my experience in conducting the investigation of Mr. Spanton in West Palm Beach, based on discussions I have had with auditors who have written up 12–701 reports, was simply that the procedures and the attitude of their management officials was such that they were not encouraged to look for indications of fraud, and in the instances that I am familiar with, none of the auditors that were involved in composing the 12-701 report had any idea of what the status of that report was after it left their office.

Chairman ROTH. No idea at all?

Mr. BATSON. No idea at all, and some of these reports were several years old.

Chairman ROTH. Mr. Murphy, would you care to comment on your experience with 12-701 reports?

Mr. MURPHY. I remember one specific instance where we found evidence of fraud at a contractor, and I called the Atlanta Region, and I was told to leave it alone, "You're not an investigator." Later on the FBI picked up on that.

Chairman ROTH. Who told you that?

Mr. MURPHY. The assistant regional manager of the Atlanta Region.

Later on the FBI picked up the contractor. He was indicted, and he is in a penitentiary today.

Chairman ROTH. The FBI did pick it up?

Mr. MURPHY. Yes, sir.

Chairman ROTH. But you were instructed to leave it alone?

Mr. MURPHY. Yes.

Chairman ROTH. How did the FBI get hold of it, do you know?

Mr. MURPHY. I don't know, sir.

Chairman ROTH. Is it possible that some higher authority might have reported it to the FBI?

Mr. MURPHY. I wouldn't know that, sir.

Chairman ROTH. You wouldn't know the answer. All right.

Mr. Batson, as you know, both DCAA regulations and the defense acquisition regulations provide auditors the right of access to necessary contractor records. In the course of the investigations, you were able to talk to auditors at various locations throughout the country. Did they discuss with you any problems they were having with respect to access to contractor records, and if so, where and to what extent were they receiving help from DCAA management in obtaining those records?

Mr. BATSON. Mr. Chairman, my discussions with the auditors employed by DCAA occurred in various locations, primarily in the States of Louisiana, Texas, Florida, Alabama, and Tennessee. When the subject matter of access to records were discussed, most of them have consistently told me that there are access problems on a continual basis in the location where they work, and most of those are with major defense contractors. The resolution of these access problems is somewhat of a mystery, because in some instances, these access problems have existed for years, some are more recent than the others, but there seems to be no firm policy or method or procedure that is being utilized to solve the problem.

Chairman ROTH. Are you able to comment on whether these were significant problems or whether they weren't? I suppose there is always some dispute in a working relationship.

Mr. BATSON. You know, until you get the records, sometimes you don't know if they are significant, but yes, I would say at least in some instances they were significant problems, yes.

Mr. MURPHY. Mr. Chairman, may I make one statement?

Chairman ROTH. Sure, please do.

Mr. MURPHY. In Texas, you asked about the significance of the problem. When I first went to Texas Instruments, I was told that I couldn't do two things: One, I couldn't go in the accounting department; and two, I could not perambulate the facilities without a company official along with me, and boy if that isn't putting the weight around the neck of the auditor, I don't know what is.

Chairman ROTH. You were not only denied access, you are saying, you were told you couldn't even go in the accounting department?

Mr. MURPHY. I was there 3 years, and today, I don't even know where the accounting department is. I was told I could not go there.

Chairman ROTH. You don't even know after 3 years where it is physically located?

Mr. MURPHY. I do not know where it is physically located.

Chairman ROTH. Is it that big?

Mr. MURPHY. Sir?

Chairman ROTH. Is it that big?

Mr. MURPHY. No, it's not that big. I know it's located on floor 2, and we were on floor 1.

Chairman ROTH. Gentlemen, my final question, at least for the moment, is to ask what this committee can do to help improve the current situation at DCAA to protect the taxpayers' dollars? Do you have any suggestions?

Mr. Spanton.

Mr. SPANTON. Well, I agree that there are many, many fine auditors in the DCAA.

Chairman ROTH. That is a very important point, and I don't want in any way, for these hearings to reflect on any auditor and frankly, as I said, we are not trying to point the finger today at any particular contractor. We may be looking into some of those at a later time, but we do want to give everybody a fair chance. I agree with you.

Many of the auditors, as the reports that we have seen reflect, often do a very competent job.

Mr. SPANTON. And these auditors are anxious to do a competent job, and they want to protect the Government's interest. They have to be reconditioned and know that they have the authority and the right to do so. They have to be retold that they no longer have to work under wraps, that their existence, that their paycheck and their benefits are going to depend upon how well or how poorly they get along with the procurement acquisition community, with the contractors, or the people within the region or the agency.

They have to be independent, so the regions and the agency claims that the DCAA has independence and they're professionals. Well, professionals and independents have to act as such and not be completely controlled so that the end product will be synonymous throughout the agency.

Chairman ROTH. If I understand what you are saying, we have got to replace the motto of getting along with the contractor with the practice of being independent and tough in representing the taxpayer.

Mr. **Spanton**. Yes, sir, and we have to retell these people that your employer is the U.S. Government, the taxpayer, and you owe them your allegiance. You are doing a job for them, and they can do the job, and the turn-around time should be minimal, because as I say, they are equipped to do the job.

You just have to be able to turn them loose.

Chairman **Roth**. Mr. Batson.

Mr. **Batson**. Mr. Chairman, my own opinion is that some form or some method of achieving independence in the Defense Contract Audit Agency is going to have to be found, and that under current conditions, unless things change awfully drastically, I don't think that that independence can be obtained in its present form.

Chairman **Roth**. Mr. Murphy.

Mr. **Murphy**. Mr. Chairman, I couldn't more succinctly state my feelings than you, Mr. Spanton, and Mr. Batson have just stated them.

Chairman **Roth**. Senator Levin.

Senator **Levin**. Mr. Chairman, you have heard some testimony this morning that auditors are being pressured not to make too many waves by some of their supervisors. I presume that that gets to the question as to whether or not the DCAA is in the right part of the Defense Department or whether we ought to put it in a more independent wing of the Defense Department.

Mr. Batson and others have suggested what we should look at.

My question to Mr. Batson is, during his investigation, did he find allegations from auditors that they were being pressured by supervisors not to ask for too much information; not to make too many waves, not to ruffle too many feathers?

Did he hear those types of allegations from more than one administrator?

Mr. **Batson**. Senator Levin, yes, I did. On numerous occasions, audit supervisors, as well as auditors, made those allegations. I will have to say that most of my experience was confined to the West Palm Beach area and the Florida area, but similar allegations have been made, although perhaps not as vocal as the West Palm Beach auditors, that there is a concern on the part of DCAA's management officials for the auditors not to ruffle feathers and disturb the procurement community.

Senator **Levin**. Did you get an official position on that issue from the head of the DCAA?

Did you check with them on their position?

Mr. **Batson**. Did I receive?

Senator **Levin**. Did you talk to them about those allegations?

Mr. **Batson**. No, Senator.

Senator **Levin**. One question on the form 1 issue.

Form 1 is a stop payment form which I understand is used where there is a contract; it is a post award audit tool.

Mr. **Spanton**. Yes, sir.

Senator **Levin**. What is the comparable preaward audit tool to the form 1?

Mr. **Spanton**. The most effective tool that the auditor has is to reject the contractor's proposal, if the contractor submits a proposal that the auditor considers inadequate as far as support and substance, then the auditor should take action to return to the procurement office and say, "We cannot work with what the contractor gave us."

Senator LEVIN. Would it then be up to the procurement officer to make a decision as to whether to go ahead?

Mr. SPANTON. It would put the burden on the procurement to pressure the contractor to comply with the requirements and give a suitable proposal that can be audited.

Senator LEVIN. But would it be up to the contracting officer to decide whether or not to go ahead under those limits?

Mr. SPANTON. Yes, sir.

Senator LEVIN. So that there, the final authority rests with the contractor?

Mr. SPANTON. Yes, sir.

Senator LEVIN. One question about the advertisements which we see, such as full-page advertisements in major media that are tooting major weapons systems. We open our newspapers, and we see that we have a paper Air Force or paper Army or paper Navy or whatever; we should buy certain weapons system so that we can close the window of vulnerability or whatever the particular ad is.

It is pretty costly stuff. Is that supposed to be reimbursible or not?

Mr. SPANTON. Those costs should not be claimed. In many situations, they consider them goodwill. They consider that they are advertising for employees. They always have an explanation, and they very often are reimbursed for those types of costs.

I agree they should not be.

Senator LEVIN. Mr. Murphy.

Mr. MURPHY. As far as the advertisement, they are unallowable.

Senator LEVIN. They are what?

Mr. MURPHY. As far as the advertisements, they are unallowable pursuant to DAR. However, the ancillary costs of those advertisements are also unallowable pursuant to DAR, in other words, the costs of preparing the ads, et cetera, unless it is deemed to be advertisement for employment, disposition of obsolete material, or acquisition of scarce material.

Senator LEVIN. I am talking about ads saying how essential a certain weapons system be put into place and be procured to protect the country. That is not supposed to be reimbursable, is it?

Mr. MURPHY. No, sir.

Senator LEVIN. Do you agree with Mr. Spanton, that one way or another, those costs are freely reimbursed?

Mr. MURPHY. Freely, they are.

Senator LEVIN. Thank you, Mr. Chairman.

Chairman ROTH. Yes, I want to express my appreciation to each one of your for being here. I think your testimony is very helpful, and I appreciate your support.

Thank you, very much.

[The prepared statements of Mr. Spanton, with enclosures, and Mr. Murphy follow:]

Statement of

Mr. GEORGE R. SPANTON

Former Resident Auditor GM-14
with the
Defense Contract Audit Agency

For Presentation at the
U.S. Senate Committee on Governmental Affairs
Hearing on the Management and Operation
of the
Defense Contract Audit Agency

March 1, 1984

George R. Spanton
1206 Coral Way
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Mr. Chairman and members of the Committee, I am George Spanton, formerly a GM-14 Resident Auditor with the Defense Contract Audit Agency at Pratt & Whitney's Aircraft plant (Government Products Division) in West Palm Beach, Florida. I retired in December of 1983.

I am a graduate of New York University with a Bachelor of Science degree in Accounting.

I have 33 years of government service including 5 years military and 28 years as a supervisor with several military audit agencies.

I appreciate this opportunity to appear before the committee to speak about the "Management and Operations of the Defense Contract Audit Agency." I believe my experience with the DCAA, particularly within the past three years, will provide you with information that will be useful to you in taking constructive action to improve the agency's audit performance.

The role of the DCAA has often been characterized as being that of a "watchdog of the defense dollar." Unfortunately, the DCAA has been anything but aggressive in performing its role. Its very existence may be creating a false sense of security among those within and outside the government who are concerned about our tax dollars and budget deficits and rely on DCAA agency auditors to protect the taxpayers' investment in our national defense.

Throughout my tenure as a DCAA auditor I saw my first responsibility as being to the government and to the taxpayer, not to the defense department procurement community. But after 1980 my attempts to disclose waste and abuse of tax dollars by major defense contractors were met with hostility and rejection by my supervisors in the agency. Not only was my work ignored, but I was continually threatened with early and unwarranted transfer if I did not retire when my bosses wanted me to retire.

When my initial attempts to correct what I considered to be procurement waste through normal channels proved futile, I was forced to pursue other avenues available to me by communicating my concern to other government agencies that have the responsibility of investigating reports of fraud, waste and abuse.

At this point I became an official "whistleblower."

Let me be more specific about my own experiences.

In February of 1982 I submitted a 12-701 report of fraud, waste and abuse through my supervisor because I found that Pratt & Whitney had violated Pentagon standards of conduct by lavishly entertaining high ranking Air Force and Navy officials. I also challenged the contractor's practice of claiming certain travel and entertainment expenses as bonafide government business. Nothing happened for five months. The Defense Criminal Investigative Service became aware of our 12-701 report during a visit to my office on another matter. It independently processed that report, without delay, in July of 1982. The DCAA, on the other hand, did not forward the report for investigation until

September of 1982. The matter is now being considered by a Federal Grand Jury in West Palm Beach.

Before giving the audit to the DCIS investigator I had contacted the General Accounting Office hotline, the Inspector General's hotline and Secretary of the Air Force, Verne Orr. I heard nothing more about the matter.

I also issued an audit in March of 1982 questioning the pay escalation at Pratt & Whitney. The report showed that raises for the company's employees were twice as high as those granted workers in the private sector, triple that for Federal employees. This was creating an ever widening salary gap beween the defense contractor and the private sector. The report was based on the assumption that the Department of Defense should hold their contractors to the same limitations that prevail in the competitive environment of private industry. We estimated that Pratt & Whitney's proposed raises would cost the government an unnecessary $150 million between 1982 and 1985.

Coincidentally, the Secretary of the Air Force issued his own directive that contractor labor costs were excessive and should be controlled.

DCAA's only response to my report was that the language be modified because it was too "inflammatory." They also wanted to know why I had not followed a specific routing procedure. The substance of that report was never addressed.

In August of 1982 the press began reporting on my audits and on what happened to me because I dared to criticize certain policies of my agency and to aggressively challenge contractors' costs. Soon the press accounts themselves became the reason I was harassed.

The retaliation I was subjected to took several forms:

1. I was threatened with an unwanted transfer to Los Angeles within 15 months of my retirement date.
2. I was the subject of a criminal investigation of anonymous allegations that I was "soft" on the contractor.
3. Pratt & Whitney requested an investigation of alleged release of Pratt & Whitney reports to the media. The request was forwarded to the Justice Department.
4. My performance ratings were substantially downgraded.
5. I was pressured to retire.
6. The agency refused to reinstate my annual leave which was lost due to DCAA management misinformation.

I would have given up the fight and accepted the transfer if it were not for the support and encouragement I received from my wife and members of my staff. I knew protection of whistleblowers was non-existent, but I decided to do what I knew was right. It was then I filed a complaint wih the Office of the Special Counsel of the Merit Systems Protection Board. After a year-long investigation, the Special Counsel concluded that I had been illegally harassed for doing my job amd recommended disciplinary action against four of my supervisors. I was the main witness at a recent hearing in which the Special Counsel pleaded its case before an administrative law judge. Regardless of the judge's decision, which is not expected for several months, I was grateful to have the opportunity to tell my side of the story and voice my criticism of the agency in a public forum. And I welcome the opportunity again today.

ACCESS TO RECORDS

The unencumbered access to the actual plant facility, the employees on the job and the contractor's financial records are esssential if DCAA is to fulfill its mission. Unfortunately, many contractors succeed in imposing limitations in varying degrees. Some examples:

A. General ledger trial balances include all of a company's accounts of its business operations. However, often the DCAA auditor has either no or restricted access to these financial documents.

B. The contractor will impose limits on an auditor's ability to perform various types of audits including operations audits. (Operations audits are reviews to determine if unnecessary costs will be incurred). The contractor refuses to provide needed data or personnel.

C. Auditors often settle for partial access to current operating budgets without variance analyses (which should be done when the actual operating costs vary substantially from the budgeted costs).

D. There is no access to the minutes of board of directors meetings and to other financial information deemed by contractor to be proprietary (executive compensation, Washington office costs, special entertainment accounts, internal audit reports, tax returns, etc.) The contractor has no proprietary information which the government does not have legitimate interest in or right to know.

The DCAA has elected to take the path of least resistance by agreeing to compromise the degree of access afforded them by the contractor and by instructing auditors to seek ways to "work with the problem." These tactics result in audits of limited usefulness which should never have been performed and reports which should never have been issued. Auditors are conditioned to by-pass access problems rather than confront the issue. They realize that attempts to resolve these access to records problems are risky because 1) the ability to work around the problem is considered a virtue and 2) performance ratings are influenced by the harmony of the contractor/auditor relationship. Also, auditors are hesitant to bring these matters to the agency's attention because in the past, agency management has too often compromised the auditor's position in blatant cases of nonaccess.

Unfortunately, auditors at some locations have been in this environment of nonaccess for so long they have been conditioned to go along with the DCAA management attiudes and fail to recognize a problem exists. Because the auditors are under constant pressure to meet deadlines, they understandably follow the agency's path of least resistance and areas of controversy are avoided. The result is a watered down audit that does not meet even the minimal standards of professionalism. They stand in stark contrast to the oft-stated claims of DCAA's independence in exercising diligent, objective and professional care in performing contract audits. Access to records is a continuing problem despite protests by DCAA management that the problem no longer exists.

I have been openly criticized for exaggerating the importance of access issues in view of our advisory role to the defense acquisition community. On several occasions when contractors balked at releasing data, the Atlanta Regional Director became personally involved and attempted to convince me that I should be reasonable and should understand the contractor's right to withold information it considered confidential or proprietary. When I persisted I was accused of being unreasonable in not attempting to cooperate with contractors in working out problems.

I was also told by a regional audit manager that if the DCAA insisted on complete access to records from all defense contractors the agency would do no audits. It would spend all its time in court arguing the issue with contractors who refused to provide complete access. I do not believe this should be a reason for acquiescence on access issues.

On another occasion I was told by an Atlanta Regional Director that my demand for access to contractor's executive compensation records be resolved on the contractor's terms by limiting our review to the minimal data that the contractor was willing to provide. My supervisor stated that I should be able to "work around the problem" as "other offices were doing under similar circumstances." His suggestion reflects the philosophy of the Atlanta region and agency, a philosophy I do not share.

Instead, I resorted to one of the most potent weapons that DCAA has at its disposal: the Form 1 Notice of Costs Suspended.

I issued a Form 1 for approximately $25 million in August of 1983. After only one month, Pratt & Whitney relented and released the data my office needed for its audit.

Inquiries at other divisions of United Technologies showed that they too had problems in obtaining executive compensation records. In fact, one resident auditor stated that they could not even get access to the general ledger. This accounting record is probably the single most important document for verifying the basic reliability of an audit.

In 1979 the General Accounting Office issued a report entitled, "The Effectiveness of the DCAA Can Be Improved" and stated that the agency does not always have access to all of the contractor's records needed to make an effective audit. It added that the DCAA should cease entering into agreements with contractors for future access to needed contractor data. In an interview with the media on this subject in August of 1982, DCAA director Charles Starrett said that the agency disagreed with the GAO's findings. He added that "the question was not whether we had access, but the extent of access to contractor data." He continued:

> "We drew up guidelines for access to budgetary information and essentially entered into agreements with contractors on what would be provided. We felt that these agreements gave adequate access and therefore accomplished their purpose."

In answer to the question of whether he knew that defense contractors were not making all records available Mr. Starrett stated:

"I don't recognize that as a problem....There are defense

> contractors that do not make certain records available and I don't care where you go when you come to such things as strategy related to their personal business; we in the government are not going to get that kind of information."

I believe Mr. Starrett's comments reveal a lack of understanding of the need for full and unencumbered access to protect the government's interests and provide insight into the reasons for the agency's difficulties.

Statutory support for access is contained in the provisions of 10 USC 2312 (a) and 10 USC 2306 (f) (3). These laws should be sufficient to achieve the required access in defense contractor plants under normal circumstances. The use of DCAA Form 1 "Notice of Costs Suspension" is an effective tool, but the agency has shown a reluctance to encourage its use. Title 10 Sec. 2276, "Inspection and Audit of Plant and Books of Contractor; Criminal Provisions" would be a most effective instrument for resolving these access problems, but neither the military procurement offices or the DCAA advocate its use.

Access to records is a pervasive agency problem which can be responsible for excessive and unwarranted costs charged to defense contracts. However, no legislation or other assistance will serve any useful purpose until a clear commitment is demonstrated at all levels within DCAA to fully implement the tools it has to protect the government's and the taxpayers' interests.

The following is an analysis of statements that Mr. Starrett made in sworn testimony before the Merit Systems Protection Board regarding the agency's views on access to records. I believe the statements reveal the extent to which the agency compromises itself on this area of utmost importance to the production of effective audits.

Mr. Starrett was asked about access to records problems at the Harris Corporation. He stated that:

> "The previous director, Mr. Fred Newman, became personally involved and.....made an agreement with them (Harris) that a public accounting firm would take a look at these particular (ten) accounts and then advise us as to what it is they'd found and give us the total amounts in the accounts so we can balance the General Ledger....Now, I don't consider that a problem, no, no.
>
> Q. That means you don't get to look at the (ten) accounts; you just get to look at what the public accounting firm tells you you need to know?
>
> A. We get to look at what the public accounting firm says is the total amount, as I recall the situation; and that amount we need in order to develop a Trial Balance, to be sure the General Ledger balances.
>
> Q. But you weren't told how the amount was developed nor what its ingredients are?
>
> A. ...We do not need that information for purposes of reviewing costs that re being incurred and determining whether or not the cost principles of the contract are met.

> Q. So there are ten accounts that are restricted at Harris Corporation. One or more, but not all ten, have to do with how much they thing they might lose.
>
> A. These are the subjects of discussions that the previous Director had and entered into on agreement that a public accounting firm would provide certain information related to those ten accounts; yes, sir. I do not consider that to be a problem."

Mr. Starrett's testimony explains why access problems continue to exist throughout the agency. Concerning Mr. Newman's actions at Harris, Mr. Starrett's testimony is inaccurate. Mr. Newman never considered that a contractor's public accounting firm was an acceptable substitute for the DCAA. He permitted the arrangement at Harris for one year, but only on the condition that DCAA would make its own verification in the subsequent period. He considered the practice highly improper. One must be naive to believe that a public accounting firm under hire by a contractor would have much concern for protecting the government's interests.

I am amazed at Mr. Starrett's contention that the information on the ten Harris accounts is unnecessary. As head of the Defense Department's chief audit agency, how can Mr. Starrett accept the contractor's explanation for the content of these accounts? How can Mr. Starrett strike a bargain that will deny DCAA auditors the right to verify the contractor's explanation? Isn't Mr. Starrett aware that the auditor's inability to examine even one account raises serious questions about the credibility of the audit? If one of my own staff members had made statements similar to Mr. Starrett's, I would have serious doubts about his audit competence.

I recently learned that Patrick Sanchez, the DCAA auditor assigned December 19, 1983 as the Resident Auditor at General Dynamics in Fort Worth, Texas announced his resignation February 27. Mr. Sanchez informed his staff that he was taking this action because DCAA regional and headquarters officials were not supporting him in his efforts to gain access to the contractor's accounting records. He described his job at General Dynamics as "extremely frustrating under these circumstances."

DCAA MANAGEMENT: THE LABOR REPORT

There are significant differences between the way Mr. Starrett manages the agency compared to his predecessors, Mssrs. Petty, Lynn and Newman. Under present direction, the DCAA is reluctant to support field offices when audit findings create conflict with the military industrial complex. The agency is now adept at reversing audit positions and will do so without hesitation in order to maintain a close relationship with the procurement "client."

A recent example of the agency's policy of sidestepping problems with the contractor was their complete reversal and abandonment of the Pratt & Whitney labor rate report.

In September 1981, because of rapidly spiraling labor costs, I recommended an agency-wide review of rate escalations in the defense industry. When the agency took no action on my recommendations, the audit was limited to Pratt & Whitney. A report was issued in March of 1982 with updated versions issued in April and August of 1982. The agency was involved, though not enthusiastically, in the review and the release of all three reports. The reports showed steep escalations and excess costs of $150 million that could be avoided over a three year period. The local AFPRO and procurement officers complained loudly about their difficulties in negotiating the audited rates which were far less than those proposed by the contractor. They even obtained a DCAS Compensation Review in October 1982 which was supposed to override our audit report. Instead, it offered them little solace. The DCAS report, in summary, considered Pratt & Whitney's rates excessive and stated that executive salaries exceeded other contractors surveyed by 40%.

In July of 1982, Mr. Paul Evans, Atlanta Regional Director wrote to Mr. Starrett about the Pratt & Whitney labor rate report saying:

> "... we believe (it) is a good effort on the field office's part to aid officials responsible for negotiating forward pricing rates. What we view as particularly beneficial is data provided the local contracing officer relative to national trends and the cost impacts of proposed contractor actions; We believe this type of visibility may be helpful at other locations where contractors may be proposing large increases in the currently changing environment."

In an interview with the media in August, 1982, Mr. Starrett echoed Mr. Evans' praise, stating:

> "The ideas in the report are very good and being pursued;..we don't have any problems with what Spanton said in his report; the Air Force is actively using these reports in negotiations."

Mr. Starrett agreed it was ludicrous that the DoD had not come to grips with the uncontrolled salary boosts of contractors while the government is kept to 4 to 5% and stated the agency was making a survey and trying to decide how to go about it. Mr. Starrett summed up by saying:

> "My general feeling is that the Defense industry has not been held down to what government employees have been getting. The Defense industry is getting more. I think it should be studied and that's exactly what we're doing."

However, Mr. Starrett's other comments in this interview were cause for concern. He stated that "the real test" was if the audited rates were negotiated and added that he "did not want to turn loose auditors out there to stomp in the woods....that on an individual basis doesn't do any good." In other words, if the negotiators did not or could not use the recommended rates because they were too tough to negotiate, then regardless of the validity of the position, the audit approach would be discarded. Mr. Starrett added "there are alot of things that come into play in these labor relations, alot of ways of looking at things." This comment seems apologetic for the excessive labor rates and would be more characteristic of a defense contractor and not the Director of the DCAA.

The pressure applied by the contractors and procurement officers to discredit the labor rate audit proved too much for the agency. In November, 1982, GAO reviewed the report and offered opposing views on the techniques used by the field audit office. The DCAA grabbed this opportunity to embrace the GAO's opinions. In their eagerness to jump on the bandwagon, the agency never provided my office the opportunity to respond to the GAO. In this case, DCAA's positive reaction to the GAO's opinion was atypical. Previously, as I indicated in my section on "Access to Records", the DCAA vehemently disagreed with GAO in its findings of problems with access, although those problems are known to exist throughout the agency. As for the labor rate report, neither GAO or DCAA gave consideration to resolving the differences or expanding the study. Thus, the potential for significant savings was ignored.

In January 1984, during a hearing before the Merit Systems Protection Board involving charges of improper acts by DCAA management, Mr. Evans gave sworn testimony on the subject of the labor rate report. It was an attack on the quality of the audit and was a complete reversal of his earlier praise and endorsement. He suffered a lapse of memory when asked about the Atlanta region's involvement in the performance of the audit and the issuance of the report. Under oath, Mr. Evans made misstatements. His criticisms of the audit were not consistent with the facts. It was apparent to me that his remarks were intended to undermine my credibility and weaken the Office of the Special Counsel's case. However, by demeaning the labor rate report, Mr. Evan's also hurt the taxpayer's interests by discouraging its implementation.

In his sworn testimony Mr. Starrett, like Mr. Evans, forgot his earlier praise of the labor rate report. He also took the opportunity to say "me too" to GAO's criticisms of the audit. He echoed much of Mr. Evans' opinions and added, "GAO just got through telling me that it wasn't worth the paper it was written on." However, he never explained why it took him five months to read the report. Of course, Mr. Starrett could not know that GAO would later retract much of what they purportedly said in their verbal exit comments with DCAA about the report. Again, it was obvious that his strategy was to undermine my credibility and weaken the Special Counsel's case against him.

The GAO representatives responsible for the February 23, 1984 report, met with me prior to its issuance. They denied making the statement attributed to them by Mr. Starrett in his testimony. They confined their evaluation to examining the accuracy and application of certain statistics used in our report. They noted that I had informed them that I was aware that the methods used in the report departed from the traditional

DCAA approach. Most importantly they stated:

> "We agree that an important, unanswered question is whether the total compensation paid in the aerospace industry is reasonable. In a separate review pursuant to your request, we are examining total compensation packages that would include labor rates and fringe benefits in the defense aerospace industry in relation to available data on employees in other industries. This review is now underway and should help address the fundamental issue raised in DCAA's March 1982 report.....We also have underway a review of DCAA audit planning, scheduling and execution with emphasis on forward pricing and incurred cost audits and the use of DCAA reports."

The GAO comments are difficult to reconcile with Mr. Starrett's comment that the report was worthless.

DCAA management's actions regarding the labor rate report illustrate the state of the current atmosphere in procurement, wherein the defense contractor virtually dictates the terms of the negotiation. What major defense contractors ask for usually establishes the baseline for negotiations. Because the government communicates the attitude that it does not want to make negotiations too difficult and operates under the assumption that the contractor will not accept auditors' positions, the contractor controls the negotiation.

FIELD AUDIT OFFICE RELATIONSHIPS AND THE REVOLVING DOOR

Relationships among our DCAA office, Pratt & Whitney Aircraft and the local Air Force Plant Representative (AFPRO) were excellent until the issuance of our reports which disclosed significant waste in labor costs and entertainment expenses. The implications of these findings and the media attention which they generated caused my superiors to conclude that I was "out of control" and that I had overstepped the bounds of acceptable reporting of potential contractor waste.

I also enjoyed a good working relationships with the comptroller of Pratt & Whitney until 1982 when Mr. Steve Harvey took over the position. At that time, I had a meeting with Mr. Harvey in which he told me that he understood I had good access to records under his predecessor, but that things would be different from now on and he was not there to make things easy for me. He was true to his word.

From what I have observed I also feel that most AFPRO representatives are not hard enough on the contractor and do not back up auditors who raise serious questions about a contractor's proposed costs. In regard to Pratt & Whitney, I believe serious "conflict of interest" questions should be raised as a result of the "revolving door syndrome," that is, the tendency of AFPRO representatives to retire to lucrative jobs with the contractor they were supposed to be monitoring.

The two predecessors of the current AFPRO representative at Pratt & Whitney are now consultants to or employed by the company. And according to the Special Counsel's investigation, the current AFPRO representative, Colonel John Roberts, conspired with DCAA and the contractor to have me fired.

In my opinion, the "revolving door" is one of the most insidious and expensive practices afflicting procurement today.

QUALITY OF AUDITS

Pressure to report large cost savings and achieve high productivity have had an adverse impact on the quality of audit performance. The audit hours allotted for review at smaller contractor locations are insufficient to allow even a minimally effective review so that auditors simply go through the motions. Desk reviews are encouraged or mandated in situations that call for on-site visits. Programming and budgeting of audit assignments have become so mechanical that individual auditors have lost their identities and become part of the mill, churning out audit reports. Artificial standards are established and there is a continuing competition to "beat" these standards, the result being even tighter budgets. Additionally, auditors are aware that the size of their paychecks is dependent upon performance criteria which emphasize productivity rather than quality.

With regard to recent disclosures of contractor abuses of spare parts pricing, certain question must be asked: where was the DCAA? Why did the agency let those "horror stories" happen? The most probable answer is that DCAA's objectives of higher productivity and increases in the rate of reported savings took precedence over the type of audits necessary to prevent the abuses in spare parts overcharging from occurring.

COST SAVINGS

The DCAA is more concerned with and spends more time and effort in generating statistics to justify its existence than in fulfilling its true mission of performing effective audits.

The agency claimed cost savings of $5.5 billion in 1982, an increase of 80% for the two years of Mr. Starrett's directorship, a truly remarkable achievement if it were true!

I can tell you that in my office I was required to report savings which, in fact, would never be realized. Considerable pressures are placed on field audit offices to report sizable savings or be penalized for ineffectiveness. I have been told by other audit office managers that they have encountered similar problems and pressures. In fact, many defense contractors have complained about the practice of citing recommendations which will not produce the stated results or of taking credit for actions initiated by the contractor.

For instance in 1981, Pratt & Whitney introduced sophisticated computer graphic equipment which reduced the number of engineering manhours needed to perform a particular design function. DCAA suggested the adoption of the equipment after Pratt & Whitney had already installed it, yet the DCAA claimed it saved the government $1.5 million.

Let me cite another example. The government pays for the health care benefits enjoyed by defense employees. DCAA claimed $240,000 savings because they suggested that employees buy generic drugs policy, and it is mandated by state law, that health insurance recipients be informed of the availability of generic drugs.

Even the Air Force insurance specialist disagreed with the DCAA on their health benefit audit.

It is ironic that when the agency has an opportunity to achieve real savings, as in controlling excessively high labor costs, their approach is one of less than enthusiasm.

REORGANIZATION OF DCAA

At a minimum, the DCAA should be transferred from the jurisdiction of the Assistant Secretary of Defense (Comptroller) to the Department of Defense Inspector General. Such a move may serve to establish some degree of true independence and should help to sever the unhealthy relationship that presently exists between the DCAA and its "client", the procurement acquisition community. Ideally, the DCAA should be combined with other DoD internal audit agencies into a new organization apart from the Defense Department. Various of our audits have disclosed significant waste which goes uncorrected because the audit agencies are not independent of the DoD.

1205 Coral Way
Singer Island, Florida 33404
13 February 1984

The Honorable Jack Brooks
Chairman, Subcommittee on Legislation
and National Security
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

Subject: Rejoinder to the General Accounting Office Draft Report on Results of Review of DCAA's 13 March 1982 Forward Pricing Labor Rate Audit at Pratt & Whitney's Government Products Division

The following comments are provided in response to the results of review by the General Accounting Office (GAO) contained in a draft report, subject: Escalation in Engineering Labor Rates at Defense Contractors (GAO/NSIAD-84-21), reference B-205285, addressed to The Honorable Jack Brooks, Chairman, Subcommittee on Legislation and National Security, Committee on Government Operations. In addition, our response to the GAO exit conferences is attached as Enclosure II.

The draft GAO report states that their "...primary objectives were to review (1) the 18.8 percent increase DCAA reported in the average engineering labor rates at Pratt & Whitney in 1981, and (2) the validity of DCAA's reported $155 million in excess costs estimated to be incurred by the government during the period 1981-1984."

Our response to the GAO draft statements is as follows:

RESPONSE TO GAO COMMENTS ON 18.8% INCREASE

We agree with the GAO that a composite rate is affected by changes in staffing relationships among the three engineering salary categories. To address the issue of disproportionate changes among the three salary categories, a special Pratt & Whitney labor rate computer listing was obtained, as explained in our report,[1] which identified and compared rates for those engineering department employees who were on board for the entire period from December 1980 through December 1981. Analysis of this special computer report (which excluded extraneous fluctuations to assure elimination of all bias among the three salary categories) disclosed that the actual pay increases in 1981 for the listed engineering department employees ranged up to a high of 37% and averaged 15.8%.[2] This 15.8% increase for the entire engineering department is in line with the GAO's reported increases of 15.2% for nonexempt engineers, 15.0% for exempt engineers and 14.1% for treasury engineers.

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[1] See 1st paragraph on page 4 [Exhibit A, page 2] of DCAA Audit Report No. 1481-2A230006 S1 dated 15 April 1982.

In addition, an analysis was made of the average labor rate for all engineering department employees on board in December 1980 versus all on board in December 1981. This analysis did not eliminate the impact of new hires, terminations and other variables. The analysis showed that the rate for December 1980 was $13.09 per hour and that the rate for December 1981 was $15.31 per hour, which represented an increase of $2.22 per hour or 17%.[1] The difference between this 17% and the 15.8% average mentioned previously reflects the impact of the changes in skill mix, turnover, transfers, etc.[3] The difference between the 17% and the 18.8% reflects the base period variation [timing] between the two computations (December 1980 compared to December 1981 rates versus average 1980 compared to average 1981 rates).

The 18.8% escalation from 1980 to 1981 represents the actual, incurred percentage increase in the average direct labor rate for all engineering department employees. This actual 18.8% increase was computed as follows:

1981 Total Engineering Labor Dollars 1981 Total Engineering Labor Hours	= $15.01 per hour
1980 Total Engineering Labor Dollars 1980 Total Engineering Labor Hours	= 12.63 per hour
Increase (difference from 1980 to 1981)	$ 2.38 per hour
1981 Percentage Increase ($2.38 ÷ $12.63) =	18.8%

Simply stated, an average hour of engineering labor cost the government $12.63 in 1980 versus $15.01 in 1981, or 18.8% more in 1981.

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[2] See last subparagraph on page 4 [Exhibit A, page 2] in 15 April 1982 report.

[3] See 1st paragraph on page 4 [Exhibit A, page 2] and also explanatory note 4 (re: timing and skill mix differences) on page 14 of our 15 April 1982 audit report.

If the GAC had viewed our use of a composite rate in its proper context, they could not have concluded that the 18.8% increase was "misleading" or "not a proper basis for measuring increases". The use of a composite rate was necessary to (i) identify the increased cost to the government of an average hour of engineering department labor, (ii) reflect the cost of other variables, especially skill mix enrichment, that result from disproportionate changes among the three engineering salary categories, and (iii) provide an average annual engineering escalation rate as used by various procurement offices to negotiate labor escalations.

The 18.8% increase in 1981 resulted mainly from salary increases, but skill mix enrichment was also a contributing factor. The skill mix enrichment was due to Pratt & Whitney's disproportional termination of lower grade engineers in 1981 (i.e., a reduction of approximately 360,000 hours[4] of primarily nonexempt engineering labor). The termination of lower level engineers was not accompanied by a proportionate reduction in exempt engineers and treasury[5] engineers. This occurred not because of changes in the mission of the engineering department, but because of Pratt & Whitney's response to declining business levels in a defense contracting environment. Our review disclosed no evidence of staff recruitment or retention problems to justify the resultant substantial rate increase in 1981.[6]

The three engineering groupings (nonexempt, exempt and treasury) are not disparate categories. The distinction between the three categories is primarily one of salary and not necessarily engineering academic degree as the GAC title of technician used for the lower salary (nonexempt) engineers would suggest. For example, new hire nonexempt engineers may be promoted to the exempt category within a year or so. The treasury engineers are exempt engineers higher than grade 48 on the salary rated schedule.

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[4] Paragraph (2), page 5 [Exhibit A, page 3] in 15 April 1982 audit report.

[5] Identified as managers in the GAC draft report although treasury category engineers are not necessarily supervisors or managers.

[6] See 2nd subparagraph on page 5a [Exhibit A, page 3a] of our 15 April 1982 report.

Composite average labor rates/escalations were specifically used in our audit report to reflect the impact of the skill mix enrichment (which resulted from the disproportinate termenation of lower grade engineers in 1981, as noted above). In addition to providing recommended rates by labor category, it was important to develop a composite escalation rate for audit report presentation purposes because of the approach utilized by various procurement offices including the Air Force Plant Representative Office (AFPRO) at West Palm Beach, Florida. This local AFPRO (Detachment 4) formulates a composite inflation rate for each year and then uses these rates in their offer to Pratt & Whitney for forward pricing rate purposes (as evidenced by section 1.b. of Attachment 4 to the 30 September 1982 Price Negotiation Memorandum[7]). Furthermore, the GAO must be aware that both the administrative contracting officer and Pratt & Whitney negotiate on the basis of a single escalation rate for the engineering department for each year because the GAO draft report states that in February 1982 [after an advance briefing of the audit results incorporated into our March 1982 report] the "...administrative contracting officer recommended increases in average general engineering rates of 9.7 percent and 9.0 percent for 1983 and 1984, respectively, as compared to the increases proposed by Pratt & Whitney of about 15.1 percent for 1983 and 12.7 percent for 1984."

RESPONSE TO GAO COMMENTS ON $155 MILLION IN EXCESS COSTS

We cannot agree with the GAO's conclusion that the $155 million was mathematically correct but questionable as to methodology. To estimate the excess costs, we used Pratt & Whitney's actual and proposed escalation rates for 1981-1984 at constant 1981 activity levels. The same procedure was followed in the application of audit recommended rates. The resultant $155 million difference consists of the following:

Direct Labor (engineering, manufacturing, test, quality, tooling and assembly)	$ 62 million
Indirect Labor	75 million
Profit	18 million
Total Excess Costs	$155 million

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[7] Issued by U.S. Air Force Hdqrs. ASD (AFSC) re: Lot XI F100 Engine Acquisition (ref. PMFB, ASD/PMF Case 2090 AL; Contract F33657-80-C-0333, P00008).

The purpose of the $155 million figure is to provide the reader with an indication of the significance of the excess costs at an assumed activity level (constant 1981 labor mix). Preciseness in magnitude is not intended. The computation is a means of assigning a monetary weight to show the potential excess cost that could be incurred if the events anticipated by the proposed rates and recommended rates transpired. It is, in effect, a measurement of the difference between "would cost" and "should cost". So long as Pratt & Whitney continues to give labor increases in line with the CPI, BLS or equivalent index, the differential will widen between the contractor's rates and the private sector due to the compounding effect of indexing contractor base labor rates which are demonstratively excessive. This fact must be given full recognition by the government in their rate negotiations until Pratt & Whitney's base labor rates are brought in line with the private sector.

Although the DAR 15-205.6 cited by the GAO draft does not provide for the use of escalations given government employees as a criterion for determining the reasonableness of increases in contractors' labor rates; neither does it prohibit its use. It is the responsibility of the DCAA field audit office to utilize audit techniques best suited to the circumstances to make a determination of reasonableness on incurred or proposed costs.

The GAO draft states that officials in DCAA's Atlanta region informed them that guidance to DCAA auditors "...does not provide for using increases in government labor rates as criteria for evaluating the reasonableness of increases in contractor labor rates" and that "none of the other audit reports they [Atlanta Region] reviewed or DCAA offices they visited used this technique to question labor costs." What the GAO draft fails to acknowledge is that this technique was being used in our office in forward pricing rate reports and in numerous contract cost proposal evaluation reports with the full knowledge and consent of both the Atlanta Region and Headquarters, DCAA. Nor is mention made in the GAO draft of the fact that the Assistant Secretary of the Air Force, in a 24 August 1982 memorandum to Air Force Financial Management and Acquisition Offices, requested that a comparison be made of the rate of increases in defense industry compensation with the increases given to active and retired Federal employees. Interest at the highest level within the Air Force in controlling spiraling defense contractor costs by means of such comparison is further evidenced by the following quote from a

15 April 1982 memorandum of Secretary of the Air Force Verne Orr:

> "I think it is absolutely ludicrous to expect all elements of government and all retirees and pensioners from government to undergo strict limitation of their receipts from our Federal Government while at the same time, through our contracts, we pay substantially larger increases to labor forces building our weapon systems.
>
> "Please make every effort to see that we do not pay negotiated wage settlements to our weapon producers which are greater than the amounts which the Federal Government decides are adequate for its own employees and recipients.
>
> "This may involve insisting that some contractors take the excess negotiated payments out of their profits. It could even involve a case where there are work stoppages.
>
> "I am fully prepared to accept work stoppages in some of our weapon acquisition programs, if that is what it takes to bring inflation under control and to bring wage settlements down to the level which the Federal Government deems adequate for its own people.
>
> "Will you see that this policy is distributed widely to the civilian and military members who negotiate with our contractors. It should be made available to the contractors before they complete labor negotiations and not after."

To accordingly facilitate such negotiations, it is ironic that the DCAA never established a procedure requiring other field offices to use this comparative technique——at least in audit reports issued to the Air Force.

As stated in our report, the Bureau of Labor Statistics (BLS) index for private industry used in our audit includes the same defense contractors that we [DCAA] are evaluating. Data is not available to segregate the impact that the defense industry has on this BLS index. Therefore we elected to use a midpoint by averaging the BLS index and Federal Government escalation rates rather than reducing the BLS index by an arbitrary amount to compensate for the impact of defense contractors on the index. Federal Government escalations were selected as a reasonable measure because the government has set an example for private industry with its curbs on Federal employee labor cost escalations covering millions of workers. We believe it is not inappropriate to expect defense contractors to follow the government's initiative and thus lead private industry in restraining spending, thereby demonstrating responsiveness to national public policy concerns as required by DAR 15-201.3(a)(iii).

The GAC suggests it is improper to link defense contractor pay increases to government pay increases, yet they offer no alternative for weighing the reasonableness of Pratt & Whitney's escalations other than (i) a comparison to the BLS index which the GAC accepted without adjustment for the impact of defense contractors on the index, and (ii) a comparison with other defense contractors in the geographic area whose base labor costs, like Pratt & Whitney's, have been shown to be substantially inflated by various reports such as the Defense Contract Administration Service's Compensation System Review cited in the 31 August 1983 DCAA Atlanta Regional Audit Memorandum entitled "Unreasonable Labor Costs".[8]

The GAC's statement, that it is unrealistic to have presumed that the government would have accepted Pratt & Whitney's proposed rates, is contradicted by the record which shows that during the six year period 1978 thru 1983 (earlier records are unavailable) the administrative contracting officer rarely accepted audit recommended rates and generally negotiated rates which closely approximated (and sometimes exceeded) the contractor's proposed rates. While the administrative contracting officer was informing the GAC that he never planned to accept the contractor's proposed escalation rates, he was recommending 8.2% for 1982 compared to Pratt & Whitney's proposed 8.5%. For 1983, the administrative contracting officer made an upward revision in his recommended rate from 9.7% to 12.5% as compared to Pratt & Whitney's revised proposed rate of 14.1%. By contrast, the actual incurred escalation rates for 1982 and 1983 were:

Category	1982	1983
Nonexempt	8.5%	6.9%
Exempt	8.1%	6.1%
Treasury	5.3%	6.4%
CPI	3.9%	3.8%

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[8] Exhibit A to 31 August 1983 DCAA Atlanta Regional Audit Memorandum No. RSO-73-83, reference RSO-1, subject: Unreasonable Labor Costs; memorandum expiration date: 31 August 1984.

The GAO, for some reason not explained, averaged the increases in engineering rates for 1978 thru 1981 at the five government contractors which they visited. They then concluded that the increases at Pratt & Whitney and the other four defense contractors "...were generally in line with one another and with the BLS indices for the private sector for 1977 to 1981." As noted above, in accepting the BLS indices as a basis for comparison to the private sector, the GAO ignored our comments that (i) defense contractors significantly impact the BLS indices because of their inclusion therein, and (ii) the continuance of increases in line with the CPI or equivalent index serves (because of the compounding effect of indexing already high defense contractor base labor rates) to widen the gap with the private sector rather than deter it.

An 18 March 1983 DCAA memorandum[9] to the Office of the Assistant Secretary of the Air Force entitled "Survey of Defense Contractors' Employee Compensation" showed the results of an interim review of escalations of direct labor rates at 81 major defense contractors for the same four years 1978-1981. The information contained in this report was in sharp contrast with the GAO conclusion that the increases for Pratt & Whitney and the other four contractors they visited were "generally in line with one another". Analysis of the survey results shows that the average increase for the 81 major defense contractors in 1981 was 11.1% for all categories of direct labor and that Pratt & Whitney's increase for 1981 was 17.1% (the highest increase of the 81 defense contractors listed in the survey). For comparison, the CPI in 1981 was 8.9% Interestingly, only one of the other four defense contractors visited by the GAO in our geographic area was listed in the survey. The survey showed that the increase for that contractor was only 6.7% for 1981. The survey also shows that for the four year period 1978 thru 1981, Pratt & Whitney ranked 13th highest of the 81 major contractors whereas the other listed contractor visited by the GAO ranked 79th.

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[9] Referenced as ODT 703.4.82 and signed by C. O. Starrett, Jr., DCAA Director (supplements "Survey of Labor Costs" dated 7 January 1983, reference OTD 703.4.63, signed by DCAA Director and addressed to Assistant Secretary of the Air Force (Financial Management) and Deputy for Acquisition, Office of the Assistant Secretary of the Air Force (Research, Development & Logistics).

On 29 November 1982, the Atlanta Region of the Defense Contract Administration Service (DCAS) issued an Employee Compensation Report on the results of their initial review of Pratt & Whitney's rate structure. The GAO draft report states that the administrative contracting officer at Pratt & Whitney asked the DCAS to perform this review because he was "...unable to use the March 1982 DCAA report in negotiations", and concluded: "In light of the composition and size of the DCAS sample, we believe DCAS's conclusion was invalid *with regard to increases in engineering salaries*." Despite GAO's misgivings, the DCAS's conclusions are worth noting:

> "Our analysis of individual salaries within the rate schedule included a comparison of employee earnings for 52 positions (representing 889 employees) to average earnings by competitors for the same/similar positions. For 40 positions (478 employees) the average salary paid by Pratt & Whitney was within the average range paid by competitors, and for 12 positions (411 employees) the average salary paid by Pratt & Whitney exceeded the average range maximum paid by competitors. Eight of the 12 latter positions were within grades 49-51. We found that average pay for 36% of the employees in grades 31-48 exceeded market levels while average pay for 97% of the employees in grades 49-51 exceeded market levels.
>
> "Based on our comparative, executive compensation (salary and bonus) is 40% higher than market levels. Incentive compensation for Pratt & Whitney Government Products Division executives exceeded that of all the companies compared. Furthermore, our analysis of exempt employee salary levels indicated that average salaries of Government Products Division employees in grades 49 and above exceed market levels."

We cannot understand the conclusion in the draft GAO report that the average increases in labor rates for engineers at Pratt & Whitney "were in line with increases in the private sector as whole". This conclusion is premature in that it contradicts the GAO draft report statement that our March 1982 report "did raise an important question about the reasonableness of total compensation paid in the defense aerospace industry." The GAO draft also states that an in-depth review "is now underway and should resolve the basic question raised in the DCAA's March 1982 report." Our question is: How could the GAO come to the above stated conclusion without completing the on-going in-depth review?

On 13 April 1983, the GAO provided Pratt & Whitney with an exit briefing on the results of their review of our labor rate report. The contractor's write-up of this exit briefing (see Enclosure I) was subsequently used by

Pratt & Whitney during various contract negotiations to convince DOD procurement officials that our audit report was of little or no value. When shown this 13 April 1983 memorandum during recent discussions, GAC officials advised us that Pratt & Whitney misstated the substance of their exit briefing. The unfortunate aspect of Pratt & Whitney's use of this memorandum is that it mislead DOD procurement officials and undoubtedly resulted in the negotiation of contracts in excess of amounts that should have been allowed. It is recommended that this action by Pratt & Whitney to mislead DOD procurement officials be submitted for investigation by appropriate authorities.

The GAC places great emphasis on the argument "...that the composite 18.8 % increase, while arithmetically correct, was not a proper basis for measuring increases in labor rates for the individual categories because it was not adjusted to eliminate the effects of significant proportional changes in the hours worked in the different labor categories...." For discussion purposes, if one were to use the GAC's approach of applying their individually computed escalation rates (of 15.2% for nonexempt salaried engineers, 15.0% for exempt salaried engineers and 14.1% for treasury engineers) instead of the actual 18.8% average escalation rate used in our report, the impact on the $155 million excess costs would be a reduction of less than $20 million or a net amount of $135 million in excess costs. However, in using this approach to incorporate GAC's computed individual rates for the three salary categories of engineers, the problem of the overgrading of engineering personnel and its related costs to the government has not been addressed.

Sincerely yours,

George R. Spanton
GEORGE R. SPANTON
DCAA Resident Auditor, Retired

Enclosures (2)

Copy furnished:

- Chairman, Subcommittee on Investigations, House Committee on Armed Services
- Secretary of Defense
- Director, Defense Logistics Agency

April 13, 1983

Today the GAO gave GPD a highly favorable exit briefing on their audit report on their analysis of the DCAA and DLA audit reports on labor escalations at GPD. The audit report concluded that the percentage salary escalations at GPD over the past five years were consistent with other aerospace industries in the Atlanta region. Further, the audit report critized the DCAA (Spanton) audit report in that it only considered one year's escalation at GPD with that year being significantly higher than the other previous years; it consolidated a number of job categories which were clearly not homogeneous and thus distorted the result; it included computational errors which projected the increases at an inflated amount; and it compared GPD salary escalations to the public sector which was an inappropriate comparison. The GAO will send their report to Washington this week and it is expected to be given to the Brook's House Committee next week. We will be able to obtain a copy of this report five days after it goes to the House Committee.

C F Cleary
C. F. Cleary
Supervisor - Contracts Liaison

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Response to GAO's Alleged Deficiencies
In P&WA Labor Rate Report

Mr. Siemering[1] claims that our report (i) contained judgment errors, (ii) failed to disclose significant information, and (iii) reached conclusions based on an inadequate information base, but he did not identify which of the report "deficiencies" fall into the cited catagories. We disagree with GAO's broad and distorted allegations and will show in what follows that these purported deficiencies are invalid.

1. GAO states that (i) the audit recommendations were based on only one year (1981) of P&W experience, (ii) no multi-year trend analysis was undertaken by the DCAA, and (iii) the 18.8 percent increase should be considered in conjunction with prior year increases. GAO's entire statement is incorrect and misleading.

In our March and April 1982 audit reports, we limited the period used to develop the contractor's labor rate escalation experience to 1980 and 1981 because of numerous accounting system changes and the significant build-up of the P&W labor force (from approximately 6000 to 8000 employees) that occurred during the prior period 1976-1979. During this period, direct engineering labor increased from 2.6 million to 4.0 million hours. It was our considered opinion that the 1976-1979 period was incompatible with the 1980-1981 data used in our review. For the August 1982 report, we expanded our data to 30 months to include actuals through June 1982. For the March and April 1982 reports we used the average of 12 months experience for 1981 as the base for projecting 1982-1984 labor rates. For the August 1982 report, we used the actual rate for June 1982 for projection purposes. The explanation of why we used the above cited periods was discussed with the GAO auditors.

Our office reviews actual labor rate trend data on a continuing basis and applies it under appropriate circumstances. GAO was furnished complete access to the audit workpapers which contained computer reports on labor rate history from 1977 through 1981, and also included analyses of escalation rates by individual years.

The GAO suggestion that the 18.8 percent increase in the 1981 labor rate should be considered in conjunction with prior years' increases over the 1978-1980 period and to conclude it therefore is reasonable, represents a fallacious and totally unacceptable arguement. One can ask why stop at 1978; why not spread it over five or ten years for that matter? Very simply stated, the 18.8 percent labor rate increase from 1980 to 1981, is an incontrovertible fact.

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[1] GAO Evaluator-in-Charge, General Procurement, Procurement, Logistics and Readiness Division.

Mr. Siemering indicated that P&W's actual labor rate history for some years was actually under the rate of inflation. This may have been true because of the significant build-up in the P&W labor force mentioned above. However, the P&W merit and COLA increases surpassed the nationwide rates in most years, as shown by the following comparison:

	P&W Merit & COLA Increases	U.S. Bureau of Labor Statistics P.A.T.&C. Engineering/ Technicians % (1)
1977	10.8%	8.5%
1978	10.1%	8.1%
1979	12.1%	10.2%
1980	7.0%	10.7%
1981	15.6%	10.0%
1982 Estimated	10.0%	Unavailable

(1) Includes significant impact on rate by inclusion of defense contractors.

The total P&W actual merit and COLA increases (compounded) for 1977-1981 was 69.2% as compared to 57.4% for the P.A.T.&C. during the same period.

We found no indication that P&W had underpaid its engineering personnel during the 1976-1980 time-frame necessitating a "catch-up" pay increase for 1981. The retention rate for salaried employees was very favorable and the new hire rate was only four percent after adjustments for total head count growth. The four percent rate remained constant after the 1981 pay increases which indicates that the raises did nothing to improve employee retention.

GAO was informed that we obtained a special computer listing from P&W to provide further insight into what appeared to be an excessive escalation rate for 1981. This report listing showed that the engineers, on the average, received pay increases of 16 percent. The average departmental labor rate increased 17 percent during the same period; the one percent difference was caused by a shift in the skill mix. We were unable to obtain this same listing for 1976-1980.

2. GAO states our report failed to show that the 18.8 percent increase between 1980 and 1981 included an amount applicable to a prior year which had been delayed due to union contract negotiations. We have no evidence to show that the 7 percent special adjustment given on 16 January 1981 was applicable to the prior year. Nevertheless, if it had been considered in December 1980, the impact on the 1981 rate would have been negligible; the 18.8 percent would have been reduced by 0.4 percent to 18.4 percent.

The GAO suggestion that the auditor should consider the date when the pay raises were intended, rather than when they actually occurred, is totally without merit. It would place the auditor in a position of having to consider various hypothesis when the facts are known. It can be asked, why didn't GAO suggest an adjustment for the December 1979 special salary increase of 4 percent which was given "up front" in December 1979 for 1980. Had GAO made both hypothetical increases, 1980 would have exceeded the national average as follows:

	P&W	U.S. Bureau of Labor Statistics P.A.T.&C. Engineering/ Technicians
December 1979 COLA intended for 1980	4%	
1980 Merit Pool	7%	
January 1981 COLA intended for December 1980	7%	
Compounded Total	19.1%	10.7%

3. GAO states that the 18.8 percent increase also includes the effects of "significant" layoffs during the period 1980-1981 which were not disclosed in the report. The exaggeration of GAO's statement that there were "significant" layoffs is brought out by the following statistics:

Year	Engineering Headcount	Net Change
1977	2,040	-
1978	2,218	178
1979	2,273	55
1980	2,042	(231)
1981	1,924	(118)
1982	1,917	(7)
Average	2,069	118

As shown, the reduction in 1981 of 118 employees equalled the average net change for the period 1977-1982. The total reduction of 349 over the two year period 1980-1981 exceeded the average change by 56 employees per year (over the "norm"), which can hardly be considered significant in a group of 2000 employees. P&W's normal attrition rate and its early retirement program have historically allowed it to achieve reductions in manning levels without resorting to significant layoffs. Furthermore, GAO can scarcely suggest that we failed to disclose the reduction of 360,000 hours of direct engineering labor in 1981 as evidenced by the following extract from page 6 of the August 1982 report:

> "Direct engineering labor decreased in 1980 and 1981 by approximately 360,000 hours, primarily in the area of nonexempt salary labor. Since the engineering workforce was in a declining mode in 1981, most promotions would be the result of restructuring the existing workforce. Our review disclosed no major changes in the mission of the engineering department."

Also on page 4 of the report we state: "Actual pay increases in engineering departments, as measured from December 1980 to December

1981, ranged up to a high of 37 percent and averaged 15.8 percent. Giving full weight to the reduction of 360,000 hours, the engineering rate would have changed from the reported 18.8 percent to 15.4 percent. While GAO may attempt to justify the increases by its various causes, the fact remains that the Government was billed 18.8 percent more for engineering direct labor rates in 1981 than in 1980. Again, if the GAO feels an adjustment is necessary in the rate for the reduction of 360,000 hours in 1980 and 1981, then wouldn't it be incumbent on GAO to make offsetting adjustments for the increases in employment that took place in 1978 and 1979?

4. GAO incorrectly opines that the audit report conclusion, in which P&W had proposed over $150 million of excess labor costs, was overstated and not supported by available audit data. GAO, without basis, adds that P&W actual labor rate history was reasonably in line with other contractors.

Again, GAO is mistaken; the $150 million of excess labor costs was detailed in the workpapers and represents a reasonable estimate at 13 March 1982 when our initial report was issued. The GAO auditors were furnished complete information on the computation of the $150 million during their review and took no issue with the amount in their exit conference at the conclusion of their review.

Concerning P&W's labor rate history, GAO's comment that they were reasonably in line with other contractors is no basis for any conclusion unless it were known that the other contractors' rates were reasonable. This has not been demonstrated and cannot be, because the national statistics used as a basis to evaluate the reasonableness of defense contractor labor rates are impacted by the very same rates being evaluated. However, a comparison can be made to the increases given Government employees for like periods to evaluate the reasonableness of P&W pay increases:

Year	P&WA Actual Merit & COLA's (c)		Government Increases (c)
1977	10.8%		7.1%
1978	10.1%		8.6%
1979	12.1%		7.1%
1980	7.0%		8.6%
1981	15.6%		10.7%
1982	10.5% (p)		6.4%
1983	13.4% (p)		5.6%
1984	13.4% (p)		1.5% (e)
Total	92.9%		55.6%
Compounded Total	140.4%		70.8%
Difference		69.6%	

(p) Proposed by P&W on 27 January 1982

(e) Current White House proposal for no COLA on 10/83 and an average 1.5% merit.

(c) COLA and merit increases are compounded.

The significance of the need to control contractor labor rates is shown by the difference of 69.6 percent between Government and P&WA pay increases over the period 1977-1984. It clearly indicates that, had P&WA exhibited the same concern for the public good that the Government did when it exercised reasonable restraints on pay raises granted Federal workers, then labor escalation costs on weapons production programs could have been reduced by 50 percent. Our contention that the defense industry is not subjected to the restraints under which private industry is forced to operate is evidenced by P&WA management's own statement whereby they boast in newspapers advertisements that their employees get better increases in compensation than employees nationwide:

> "PRATT & WHITNEY OFFERS
> MORE, NOT LESS, FOR EMPLOYEES
> Pay cuts, freezes, COLA wipeouts, benefit reductions——they are all common in America in these tough economic times. But not at Pratt & Whitney. The company has proposed to the union a new three-year agreement providing solid economic gains and improved benefits for employees - plus major breakthroughs in job and income security..."

Sunday Republican 28 November 1982
(See Attached)

A DCASR/Atlanta review was performed at the request of the AFPRO, West Palm Beach to evaluate the validity of our labor rate report findings and recommendations by making an independent study of P&W's employee compensation. While their review did not examine the concepts for controlling pay escalations used in our audit, they nevertheless concluded that P&W employee compensation was excessive in certain areas. Their findings, which were based upon comparisons to other defense contractors, were reported 29 November 1982 and included the following:

Overall Conclusions:

"Formal policies and procedures used by GPD describe intended practices in terms of 'general guidelines' to be used by supervisors. Significant discretion (in the areas of starting salaries, merit increases, promotion increases, special awards recommendations, paid absences, etc.) is granted these supervisors in administering the compensation program. The results of the review indicate that, in most respects, the Contractor has adequate policies and procedures and implements them in such a manner as to generate compensation costs which would ordinarily be considered reasonable. However, the significance of those policies/procedures and practices which are considered inadequate indicates that the system will generate compensation costs which do not meet the tests of reasonableness, allowability and allocability in accordance with DAR 15-205."

Salaried Employees:

"GPD is primarily the engineering segment of the P&WA Group. Average annual salary increases for Engineers nationwide have been 8.4 percent, 9.8 percent and 10.9 percent for 1979, 1980 and 1981, respectively. Our findings indicate that GPD average annual increases have exceeded these levels.

It is considered, future labor escalations should be more in line with national and local escalations for exempt and non-exempt positions, respectively. Further, supervisors and managers should comply with Company policies/procedures."

Executive Compensation:

"Based on our comparative, executive compensation (salary and bonus) is 40 percent higher than market levels. Incentive compensation for GPD executives exceeded that of all the companies compared. Furthermore, our analysis of exempt employee salary levels (detailed in Section E) indicates that average salaries of GPD employees in grades 49 and above, exceed market levels."

Employee Benefits:

"Total employee benefit costs equate to 45.6 percent of payroll or $10,706 per employee compared to an Industry average of 36.4 percent or $7,931 per employee (refer to summary in Section F). Major differences are in the areas of Pensions and Group Insurance payments, for time not worked and contributions to the employee savings plans."

In a meeting with General Dever, AFCMD on 30 October 1982, Colonel John Roberts, Commander of the local AFPRO stated that "he would like to personally thank Mr. Spanton for issuing the audit report that resulted in the compensation review", and added that "George had done a great service".

It is obvious that the Congress and the Executive Branch desire to sharply curtail Government labor costs as shown by the increases given and planned for the three years ending 1984, totaling 13.5 percent. It is equally obvious that the uncontrolled area of defense contractor labor costs, as demonstrated by the planned increases of 37.3 percent by P&WA during the same three year period, must similarly receive the attention of the Congress and the Executive Branch if meaningful controls over defense spending are to be established. Labor costs are driven up throughout the economy because defense contractors can bid up the wages and absorb the best technical talent; few private concerns can afford to outbid the defense contractor. The need for establishing some form of control is apparent when it is considered that estimated defense contractor labor costs will amount to $122 billion of the $162 billion intended for defense contracts in 1983.

ATTACHMENT

Pratt & Whitney's Final Offer:

MORE, NOT LESS, FOR EMPLOYEES

Pay cuts, freezes, COLA wipeouts, benefit reductions — they're all common in labor settlements across America in these tough economic times. But not at Pratt & Whitney. The company has proposed to the union a new three-year agreement providing solid economic gains and improved benefits for employees — plus major breakthroughs in job and income security.

Three-year wage and COLA increases average $2.01, or 19.8%.

Current 84-cent COLA folded into first-year base rates

1st year: Increases up to 88 cents an hour, averaging 63 cents.

2nd year: Increases up to 90 cents, averaging 69 cents.

3rd year: Increases up to 90 cents, averaging 69 cents.

Faster wage progression — 10 cents every 24 weeks to maximum rate.

COLA — 5 cost-of-living adjustments, each up to 18 cents, totaling up to 90 cents over 3 years.

SPECIAL RETIREMENT SUPPLEMENTS — Voluntary program during the first 3 months of 1983 for employees 55 or older with 25 or more years' credited service. Special supplement up to $10 a month for each year of credited service paid to age 62 or for 4 years, whichever is longer, but not beyond 65. However, employees 64 or older can receive supplements for one year.

SEVERANCE PAY — Weekly benefits equal to 50% of 1 week's pay including COLA for up to 12 weeks, depending on seniority, for employees with at least 3 years' seniority who must be laid off indefinitely.

STRENGTHENED SENIORITY — Greater protection against layoff for longer-service employees through consolidation of job groupings and reduction of number of seniority areas in the East Hartford plant.

Seniority recall rights, now at 2 years' maximum, extended to 5 years' maximum.

INSURANCE — Company continues to pay full cost of health and dental insurance, despite increase in cost in 1983 to more than $900 for individual coverage and nearly $2,400 for family coverage.

Weekly disability income maximum raised to $200 on Jan. 1, 1985 ... still 52 weeks of coverage.

Lifetime major medical maximum raised from present $100,000 to $250,000.

Dental: Payments increased for Class II (fillings) and III (dentures) procedures. Age limit removed for orthodontic treatment for employees and dependents, and maximum benefit raised 50% to $750 in January, 1985.

PENSIONS — Guaranteed maximum monthly pension per year of credited service increased to $20 on Jan. 1 1983 ... rising to $21 on Jan. 1, 1984.

New retirement benefit for surviving spouses of employees with 10 or more years' service who die before age 55.

SAVINGS PLAN — Employees' maximum weekly savings opportunity increased to $12 on Jan. 1, 1983 ... $14 on Jan. 1, 1984 ... and $16 on Jan. 1, 1985 — with company providing 50% match.

OTHER BENEFITS — Christmas minivacation preserved with 12 paid holidays in 1st and 2nd contract years and 13 in 3rd year ... paid military leave increased from 10 to maximum of 30 days ... more than 30% increase in cash performance awards ... up to 5 weeks' vacation, as at present.

PAY PROGRESS FOR EMPLOYEES

Job Grade	11	10	9	8	7	6	5	4	3	2	1
Current Maximum Rate	$ 8.27	$ 8.54	$ 8.92	$ 9.34	$ 9.80	$10.29	$10.83	$11.41	$12.02	$12.73	$13.44
Maximum Rate Nov, 1985	9.79	10.13	10.59	11.10	11.66	12.25	12.89	13.58	14.32	15.18	16.07
Total Three Year Increase	1.52	1.59	1.67	1.76	1.86	1.96	2.06	2.17	2.30	2.45	2.63

General Increases: Nov. 28, 1982, December 5, 1983, December 3, 1984

COLA Increases: May 30, 1983 December 5, 1983, June 4, 1984, December 3, 1984, June 3, 1985

Rates in 1985 assume [illegible]

The three year package summarized here is the company's final offer. The company has told the union it will carefully consider any proposals that do not increase the total value of the offer.

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-205285

Expedite [illegible]
2/21 or [illegible]

The Honorable Jack Brooks
Chairman, Subcommittee on Legislation
and National Security
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

Subject: Escalation in Engineering Labor Rates at Defense Contractors (GAO/NSIAD-84-21)

In response to your September 17, 1982, request and subsequent discussions with your office, we have reviewed a report issued in March 1982, by the Defense Contract Audit Agency (DCAA) at the Pratt and Whitney Aircraft Company, West Palm Beach, Florida. The report dealt with increases in Pratt and Whitney's labor rates for engineers and other employees in 1981 and with increases proposed for 1982, 1983, and 1984 for a forward pricing labor rate agreement between Pratt and Whitney and the Department of Defense (DOD). (Forward pricing labor rate agreements are voluntary agreements between contractors and the government which estimate future labor rates to facilitate pricing anticipated contracts during specified future periods.)

As agreed with your office, our primary objectives were to review (1) the 18.8 percent increase DCAA reported in the average engineering labor rates at Pratt and Whitney in 1981, and (2) the validity of DCAA's reported $155 million in excess costs estimated to be incurred by the government during the period 1981-84.

The details of the results of our review are included in enclosure I and are summarized below.

DCAA reported that a substantial increase in Pratt and Whitney's average engineering labor rates in 1981 and proposed increases for 1982-84 would result in excess cost to the government of over $155 million. DCAA considered these increases to be excessive because they were substantially higher than its estimates of the increases experienced and to be experienced by government and private sector workers. DCAA recommended to the Air Force administrative contracting officer that he negotiate downward adjustments in the Pratt and Whitney proposed labor rates to bring them more in line with government and private sector pay increases and to offset excess costs alleged by DCAA to have been incurred in 1981.

The 18.8 percent labor rate increase reported by DCAA was the difference between 1980 and 1981 composite average labor rates for the three classifications of engineering employees at Pratt and Whitney. It was overstated because it was not adjusted to eliminate the effects of changes in the proportion of hours worked by higher paid engineers compared to lower paid technicians. Increases in labor rates for the three separate categories were 15.2 percent for technicians, 15.0 percent for engineers, and 14.1 percent for managers. Although these increases were high, even after adjustment for the change in hours, we found that they were not representative of the trend at Pratt and Whitney for previous years. Its annual labor rate increases for engineers for the prior 3 years ranged from 5.8 to 8.0 percent.

While we found that the $155 million estimate of excessive cost was mathematically correct, we believe that DCAA's estimate is questionable. In its computation DCAA departed from established practices and made assumptions which did not reflect adequate consideration of the underlying uncertainties.

The $155 million estimate was based on a comparison of Pratt and Whitney experienced and proposed increases with an average of similar increases for private industry and the Federal government. The use of Federal increases, which resulted in lowering the average increase used in the comparison, was a departure from Defense Acquisition Regulation (DAR) guidance. If this guidance had been followed, the estimate would have been reduced by about $30 million. Moreover, the estimate was based on an assumption that the government would accept the labor rates proposed by Pratt and Whitney without modification, even though the contracting officer had earlier recommended the use of Pratt and Whitney's proposed rate for 1982, but lower rates than those proposed for 1983 and 1984. Finally, while relatively large increases in labor rates can lead to unreasonably high labor costs, a conclusive determination and comparison can only be made by examining the total compensation package from year to year. The DCAA report focused on increases in labor rates rather than total compensation. Use of total compensation data could materially increase or reduce DCAA's estimate of excessive cost.

Because DCAA believed that Pratt and Whitney's labor increases were excessive in 1981, it recommended that 1982 and

1983 increases for the forward pricing rate agreement be limited to offset the excessive costs. In our view, DCAA's recommendations were not appropriate given (1) the purpose and nature of forward pricing agreements, and (2) the questions that can be raised about DCAA's estimate of excessive costs.

You also asked us to determine whether (1) increases in average labor rates at Pratt and Whitney and at four other contractors were excessive in relation to the increases for government and private sector employees, as reported by the Bureau of Labor Statistics (BLS) in its nationwide survey, and (2) the administrative contracting officers at selected contractors utilized DCAA's findings and recommendations in negotiating forward pricing labor rate agreements.

In reviewing the average increases in labor rates for engineers at the five contractors we visited, including Pratt and Whitney, we found that the 4-year (1977-81) averages for such increases were in line with increases in the private sector. Pratt and Whitney increases for 1981 were substantially higher than three of the four contractors and the private sector. Increases at the five contractors and in the private sector were generally higher than increases in government rates.

We also found that contracting officers at three of the other four contractors we visited utilized DCAA's assistance and recommendations during labor rate negotiations. The fourth contractor has not had a forward pricing agreement for labor rates for several years; and in light of the problems relating to the DCAA report, the administrative contracting officer at Pratt and Whitney did not attempt to negotiate the rates proposed by DCAA in the March 1982 report. A forward pricing agreement has not been negotiated with Pratt and Whitney since 1980.

The objectives, scope, and methodology of our review are described in enclosure II. We did not obtain official agency or contractor comments on this report, but we briefed DCAA officials on our findings relating to its March 1982 report.

The DCAA resident auditor responsible for preparing the March 1982 report informed us in January 1984 that he was aware that the methods used in the report departed from the traditional DCAA approach. He said the purpose of his report was to focus attention on what he believed were excessive wage rates in the aerospace industry. We agree that an important unanswered question is whether the total compensation paid in the aerospace industry is reasonable. In a separate review pursuant to your request, we are examining total compensation packages that would include labor rates and fringe benefits in the defense aerospace industry in relation to available data on employees in other industries. This review is now underway and should help address the fundamental issue raised in DCAA's March 1982 report. We also have underway a review of DCAA audit planning, scheduling and execution with emphasis on forward pricing and incurred cost audits and the use made of the DCAA reports.

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We are sending copies of this report to the Chairman, Subcommittee on Investigations, House Committee on Armed Services, who also requested that we review the validity of the DCAA report. We are also sending copies to the Secretary of Defense; the Director, Defense Contract Audit Agency; the Director, Defense Logistics Agency; and the President, Government Products Division, Pratt and Whitney Aircraft Company.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

Enclosures

EVALUATION OF DCAA REPORT ON ENGINEERING LABOR RATES

BACKGROUND

On January 29, 1982, prior to negotiations with Pratt and Whitney, the Air Force administrative contracting officer followed normal procedures and requested DCAA to provide an evaluation of the reasonableness of Pratt and Whitney's proposed labor rates for a planned forward pricing rate agreement for 1982, 1983 and 1984. DCAA's report was intended to be used by the administrative contracting officer in negotiating reasonable labor rates for the forward pricing agreement.

Forward pricing labor rate agreements are negotiated written agreements between contractors and the government which establish projections of labor rates to facilitate pricing anticipated contracts during specified future periods. They are administrative tools used to reduce the time and costs associated with contract negotiations between contractors and the government by establishing labor rates for future periods to be used by the contractor for preparing proposals and by the government for evaluating them.

On March 13, 1982, DCAA reported to the administrative contracting officer that Pratt and Whitney's actual labor rate increases in 1981 and the increases proposed for 1982 through 1984, would result in excessive costs for labor (both direct and indirect) and profit of more than $155 million for the 4 year period 1981 to 1984.

The DCAA report stated that it was based on the following considerations:

--Government contractors should lead private industry in restraining spending particularly in the area of labor costs where they have almost absolute control.

--Contractor labor rates should be managed judiciously so that escalation approximates a midpoint range between private industry rates and those of Federal employees.

--Pratt and Whitney's failure to control labor rates adds to the bidding up of labor costs in the defense industry and contributes to labor inflation throughout the economy.

--Lack of fiscal responsibility with regard to labor costs could eventually lead to the downfall of the defense industry in the face of international competition.

Officials in DCAA's Atlanta Regional Office reviewed the March 1982 report and the report was reissued to the administrative contracting officer in April 1982 after some language in the report was moderated. In June 1982 Pratt and Whitney updated its proposal to reflect a reduction in its proposed labor rates, and the updated rates were also evaluated by DCAA. The resulting DCAA report was provided to the administrative contracting officer in August 1982. Although changes were made to the original March 1982 report to reflect later information, DCAA's recommendations, conclusions and methodology remained essentially unchanged in all three reports. Consequently, for the sake of clarity, our comments are referenced to the DCAA March 1982 report only.

While there is currently considerable controversy surrounding the DCAA report, the Director of DCAA's Atlanta Region, in a July 16, 1982, memorandum to the DCAA Director made the following comments about the report.

> "The data is forwarded to you to show what we believe is a good effort on the field office's part to aid officials responsible for negotiating forward pricing rates. What we view as particularly beneficial is data provided the local contracting officer relative to national trends and the cost impacts (cumulative) of proposed contractor actions. We believe this type visibility may be helpful at other locations where contractors may be proposing large increases in the currently changing environment."

The Director of the Atlanta Region said that when he wrote the memorandum, he had in mind the audit staff's research pertaining to (1) the private sector labor rate indices to show what was happening in the market place, and (2) the changing inflationary environment and national trends. He said that he also felt that the graphs which compared labor indices for the private sector and government were meaningful information.

DCAA'S CALCULATION OF THE 18.8 PERCENT

The March 1982 report stated that there was an 18.8 percent increase in the average engineering department labor rate for Pratt and Whitney from 1980 to 1981. The 18.8 percent is the difference between the composite average labor rate for three dissimilar skill and pay levels of employees, and was not adjusted to eliminate the effects of changes in the proportion of hours worked by higher paid engineers compared to lower paid technicians from 1980 to 1981. As a result, the 18.8 percent figure is higher than the 1981 labor rate increases for Pratt and Whitney's three separate engineering department categories of labor (15.2 percent for technicians, 15.0 percent for engineers, and 14.1 percent for managers) by 3.6, 3.8, and 4.7 percentage points, respectively.

The following table shows DCAA's calculations of the composite increase of 18.8 percent in the average labor rate for the engineering department. Because Pratt and Whitney considers actual labor rate data to be proprietary, we adjusted the data. However, the data reflect the same relationships and variances as the actual data for labor hours and rates.

	1980			1981			
Labor[1] Category	Salaries	Hours	Average Hourly Rate	Salaries	Hours	Average Hourly Rate	Percent Increase
Technicians	$ 1,861	292	$ 6.37	$ 1,483.50	202	$ 7.34	15.2
Engineers	6,767	630	10.74	7,734.20	626	12.35	15.0
Managers	1,372	78	17.59	1,505.60	75	20.07	14.1
	$10,000	1,000	$10.00	$10,723.30	903	$11.88	18.8

[1] Pratt and Whitney's Engineering department labor pool is comprised of three categories of labor—salary nonexempt (engineering technicians), salary exempt (engineers), and treasury (management engineers). Exempt and nonexempt refers to the requirements of the Fair Labor Standards Act.

Relying on Pratt and Whitney data which aggregated the total salaries and hours worked by the three labor categories in the engineering department, DCAA compared the average 1980 hourly rate of $10 ($10,000 in total salaries received divided by the 1,000 total hours worked) to the corresponding 1981 rate of $11.88 ($10,723.30 in total salaries received divided by the 903 total hours worked). The increase of $1.88 in the overall average hourly rate from 1980 to 1981 represented an 18.8 percent increase.

The composite 18.8 percent increase is arithmetically correct. It should have been adjusted, however, to eliminate the effects of significant proportional changes in the hours worked in the different labor categories before making any comparison with BLS nationwide averages. For example, the total hours worked by the lower paid technicians decreased by 30.8 percent and the hours worked by engineers and managers decreased by only .63 and 3.8 percent, respectively. The DCAA resident auditor told us that he was aware that there was a change in the skill mix, but he did not consider it significant in making his calculation. He believed that the nature of the work had not changed to require a higher proportion of skilled engineers and attributed the significant decrease in technicians to layoffs because of declining business.

The computation of average labor rate increases is very sensitive to changes in the number of hours worked by the various labor categories. To illustrate, if the number of hours worked by technicians had increased by 30.8 percent rather than decreased by that amount, without any change in individual labor rates, the composite increase for 1980-81 would have been only 11.2 percent rather than 18.8 percent. Conversely, the composite rate would have been higher than the 18.8 percent if the hours worked by technicians had decreased further.

Because the actual increases in Pratt and Whitney's average labor rates in 1981 were high in relation to the nationwide BLS indices for engineers in the private sector, we reviewed increases in prior years for engineers[2] to determine if this was a trend at Pratt and Whitney. The following table compares increases at Pratt and Whitney for engineers with increases in nationwide BLS averages from 1977 to 1981.

Comparison of Annual Percent Increase in Average Engineering Labor Rates

	1977 to 1978	1978 to 1979	1979 to 1980	1980 to 1981
Pratt and Whitney	7.2	5.8	8.0	15.0
Nationwide BLS average	9.0	8.4	9.8	10.9

The relatively high increase in Pratt and Whitney's 1981 average labor rate shown above was due primarily to a 7-percent general salary increase in January 1981 plus merit increases averaging 7 percent in that year. There was no general salary increase in 1980. Previous general salary increases were given in December 1979 (4 percent) and in September 1978 (3 percent). Pratt and Whitney officials stated that factors influencing their 1981 decision were (1) double digit inflation during 1979-80, (2) the high average starting salaries that had to be provided to college graduates with engineering and science degrees relative to salaries for employees with 1 or 2 years experience, and (3) a recent settlement with the machinists union representing hourly workers. Pratt and Whitney officials could not provide us with any supporting documentation to show how they arrived at the 14 percent merit and general salary increases in 1981.

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[2] This analysis includes only engineers (salary exempt category) and not technicians or managers. Engineers accounted for about 65 percent of engineering labor costs in 1981.

DCAA'S ESTIMATE OF $155 MILLION IN EXCESSIVE COSTS AND RECOMMENDED ADJUSTMENTS

DCAA concluded that increases in Pratt and Whitney's labor rates in 1981 and increases proposed for 1982, 1983, and 1984 for the forward pricing rate agreement would result in excessive costs to the government of over $155 million. That estimate was based on the difference between (1) labor rate increases experienced by Pratt and Whitney for 1981 along with increases proposed by Pratt and Whitney for 1982, 1983, and 1984, and (2) DCAA's estimates of reasonable increases for the 4 years. This difference was then applied to constant labor hour totals for each of the 4 years. For purposes of illustration, these differences for Pratt and Whitney engineers are shown below.

	Percentage increases			
	1981	1982	1983	1984
Pratt and Whitney actual increase[3]	15.0	-	-	-
Pratt and Whitney proposed increases[4]	-	8.2	15.1	12.7
DCAA's estimate of reasonable increases	9.0	6.7	7.3	6.8
Difference (percentage points)	6.0	1.5	7.8	5.9

DCAA made similar calculations for Pratt and Whitney's other labor categories such as manufacturing, and then calculated the total excessive costs, including indirect labor and profit for each of the 4 years, as follows.

Year	Dollar amount
1981	$ 15,354,657
1982	23,438,412
1983	46,655,280
1984	70,003,871
	$155,452,220

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[3] The 15 percent used in the computation is the actual increase experienced by Pratt and Whitney engineers only. The 18.8 percent composite rate discussed beginning on page 6 was used inappropriately by DCAA in offsetting proposed rates for 1982 and 1983 (see p. 10).

[4] Pratt and Whitney's actual average engineering labor rate increased by 8.1 percent in 1982 and by 5.9 percent through November 30, 1983.

The $155 million estimate of excessive costs was mathematically correct. However, the $155 million estimate was based on a comparison of Pratt and Whitney experienced and proposed increases with an average of similar increases for private industry and the Federal government. As explained on page 11, the use of Federal increases, which resulted in lowering the average increase used in the comparison, was a departure from DAR guidance. If this guidance had been followed, the estimate would have been reduced by about $30 million. Moreover, the estimate was based on an assumption that the government would accept the labor rates proposed by Pratt and Whitney without modification (see p. 12). Finally, while relatively large increases in labor rates can lead to unreasonably high labor costs, a conclusive determination and comparison can only be made by examining the total compensation package from year to year. The DCAA report focused on increases in labor rates rather than total compensation. Use of total compensation data could materially increase or reduce DCAA's estimate of excessive cost.

We believe that DCAA's estimate is questionable, because in its computation DCAA departed from established practices and because it made assumptions which did not reflect adequate consideration of the underlying uncertainties.

Because DCAA believed that Pratt and Whitney's labor increases were excessive in 1981, it recommended that 1982 and 1983 increases for the forward pricing rate agreement be limited to offset the excessive costs. The following table shows how DCAA recommended limiting labor rate increases in the forward pricing rate agreement for the engineering department to offset the 1981 excessive costs.

	Percentage increases			
	1981	1982	1983	1984
DCAA's estimate of reasonable increases	9.0	6.7	7.3	6.8
DCAA's calculated actual increase	18.8	-	-	-
DCAA's recommended increases	-	2.5	2.5	6.8
Amount to be offset	(9.8)	-	-	-
Amount offset		4.2	4.8	-0-

In summary, DCAA recommended significantly lower rate increases than proposed by Pratt and Whitney for the forward pricing rate agreement. In our view, DCAA's recommendations were not appropriate given (1) the purpose and nature of forward pricing agreements (see p. 12), and (2) the questions that can be raised about DCAA's estimate of excessive costs.

The DCAA resident auditor responsible for preparing the March 1982 report informed us in January 1984 that he was aware that the methods used in the report departed from the traditional DCAA approach. He said the purpose of his report was to focus attention on what he believed were excessive wage rates in the aerospace industry. We agree that an important unanswered question is whether the total compensation paid in the aerospace industry is reasonable. In a separate review, we are examining the industry's compensation packages.

LABOR RATE INCREASES LINKED TO INCREASES FOR GOVERNMENT EMPLOYEES

DCAA's estimates of reasonable increases in Pratt and Whitney's engineering labor rates were based on simple averages of its estimates of actual increases for government employees and for engineers and engineering technicians in the private sector as a whole for 1981 and projected increases for 1982, 1983, and 1984 as shown below.

	Percentage increases			
	1981	1982	1983	1984
Government increases	8.0[a]	5.4	6.6	5.5
Private sector increases	10.0[b]	8.0	8.0	8.0
DCAA's estimate of reasonable increases	9.0	6.7	7.3	6.8

a/ DCAA's estimated government increase of 8.0 percent differs from our 8.7 percent increase shown on page 13, because DCAA weighted the effects of pay increases granted in October 1980 and 1981, while we used published BLS data without adjustment.

b/ This 10.0 percent escalation rate differs from the BLS 10.9 percent rate shown on page 13, because DCAA included both engineers and engineering technicians in this calculation.

DAR 15-205.6, which is included in an appendix to DCAA's Contract Audit Manual, provides that compensation paid by a contractor is reasonable to the extent that it is based on the contractor's established policy and conforms generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area for similar services. This DAR provision does not provide for the use of increases in labor rates for government employees as criteria for determining the reasonableness of increases in contractors' labor rates.

Officials in DCAA's Atlanta region informed us that guidance to its auditors does not call for using increases in government labor rates as criteria for evaluating the reasonableness of increases in contractor labor rates. Also, they informed us that none of the other audit reports they reviewed or DCAA offices they visited used this technique to question labor costs.

ADMINISTRATIVE CONTRACTING OFFICER DID NOT ACCEPT 1983 AND 1984 INCREASES PROPOSED BY PRATT AND WHITNEY

In February 1982, pending DCAA's review of the labor rates proposed by Pratt and Whitney, the administrative contracting officer recommended--based on his own evaluation of the proposal--that procuring agencies use the proposed rate increase of 8.2 percent in negotiating contracts with Pratt and Whitney for 1982, but lower rates than those proposed for 1983 and 1984. For example, the administrative contracting officer recommended increases in average general engineering labor rates of 9.7 percent and 9 percent for 1983 and 1984, respectively as compared to the increases proposed by Pratt and Whitney of about 15.1 percent for 1983 and 12.7 percent for 1984.

Subsequently, as a result of the problems relating to the DCAA report, the administrative contracting officer at Pratt and Whitney did not attempt to negotiate the rates recommended by DCAA. A forward pricing agreement has not been negotiated with Pratt and Whitney since 1980. A Pratt and Whitney official told us that a forward pricing rate agreement had not been negotiated because Pratt and Whitney's position and that of the government are too far apart.

Relatively lower increases (8.1 percent in 1982 and 5.9 percent through November 30, 1983) were experienced by Pratt and Whitney. We did not inquire into the reasons for these lower increases. The DCAA resident auditor believes these lower rates were influenced by the DCAA audit report.

FORWARD PRICING RATE AGREEMENTS ARE NOT BINDING

DCAA recommended that labor rate increases for the forward pricing rate agreement be limited to take into account government-wide pay increases in 1982, 1983, and 1984 and to offset excessive costs incurred by the government under contracts in 1981. This recommendation does not adequately recognize the purpose and nature of a forward pricing agreement.

Forward pricing rate agreements are written agreements between contractors and the government to make projections of costs such as labor rates available for pricing contracts during specified periods. DAR 3-807.8 provides that the agreements (1) are not binding and can be rescinded by either party at any time for any reason, and (2) do not relieve contractors from the responsibility of basing contract proposals on current, complete, and accurate cost or pricing data as required by other sections of the DAR and Public Law 87-653 (Truth-In-Negotiations Act). Therefore, if a forward pricing rate agreement does not reflect current, complete, and accurate cost or pricing data at the time a specific contract is negotiated, neither the contractor nor the government should use it to price the contract.

COMPARISON OF CONTRACTOR, PRIVATE SECTOR AND GOVERNMENT LABOR RATE INCREASES

As shown by the following table, average increases in Pratt and Whitney's labor rates for engineers[5] and the average rates of the other four contractors we visited were generally in line with one another and with the BLS indices for the private sector for 1977 to 1981. Pratt and Whitney rates for 1981 were substantially higher than three of the four contractors and higher than the private sector BLS index. For the four contractors for which data was available for the entire period, increases were higher than the federal employees' average increases for 1977 to 1981.

Comparison of Average Engineering Labor Rate Increases

	1977 to 1978	1978 to 1979	1979 to 1980	1980 to 1981	Average annual increase
Pratt and Whitney	7.2	5.8	8.0	15.0	9.0
Contractor A	5.8	6.0	10.2	16.0	9.5
Contractor B	5.2	3.9	8.3	12.7	7.5
Contractor C [a]	-	-	11.8	7.7	9.8
Contractor D	8.6	10.3	8.5	9.0	9.1
Nationwide BLS average	9.0	8.4	9.8	10.9	9.5
Federal government [b]	7.3	5.5	6.6	8.7	7.0

a/ Data was not readily available for the entire period at contractor C.

b/ Percentage increases apply to all categories of Federal workers, including engineers.

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[5] As with the table on page 8, this analysis includes only engineers, and not technicians and managers.

We did not review the overall reasonableness of labor rates or total compensation packages at these contractors.

The contractor and BLS labor rate data are not precisely comparable. For example, nationwide BLS increases and contractors A and C are based on March data of each year, but the increases for contractor B are based on July data and the increases for contractor D are based on October data. However, we do not believe the variations in reporting dates significantly affect the results of the comparisons.

OTHER CONTRACTING OFFICERS USE DCAA LABOR RATE RECOMMENDATIONS

We found that the administrative contracting officers at three of the four additional contractors we visited used DCAA's assistance and recommendations during labor rate negotiations with contractors. (One of the four contractors, contractor C, has elected not to have a forward pricing agreement for labor.) Also, the rate agreements that were negotiated were consistent with DCAA recommendations. In fact, at contractor D, a DCAA auditor negotiated the forward pricing agreement with the approval of the administrative contracting officer. At contractor A, the administrative contracting officer accepted the contractor's proposed labor rates even though they were slightly higher than DCAA's recommended rates. DCAA agreed with the administrative contracting officer's actions because the rates were close to its estimates.

DCAS REPORT ON PRATT AND WHITNEY EMPLOYEE COMPENSATION

In May 1982 the administrative contracting officer at Pratt and Whitney asked the Defense Contract Administration Service (DCAS) to perform an employee compensation system review because the contracting officer was unable to use the March 1982 DCAA report in negotiations. DCAS is an agency within DOD that provides contract administrative services to Federal agencies, such as performing wage rate studies at contractors' plants. On November 29, 1982, DCAS reported among other findings, that increases in the average engineering salaries at Pratt and Whitney exceeded nationwide increases reported by BLS for 1979, 1980, and 1981.

While the DCAS report dealt with total compensation, it did suggest a possible difference with our findings concerning increases in engineering labor rates. We met, therefore, with DCAS officials to determine the reasons for the differences. We found that the DCAS conclusion on increases in engineering salaries was based on a judgmental sample involving 84 employees which, in addition to engineers, included file clerks, draftsmen, budget analysts and others. In light of the composition and size of the DCAS sample, we believe DCAS's conclusion was invalid with regard to increases in the average engineering salaries.

OBJECTIVES, SCOPE, AND METHODOLOGY

As agreed with the Subcommittee, we limited our objectives to reviewing (1) DCAA's reported 18.8 percent increase in the average engineering labor rates at Pratt and Whitney in 1981, (2) the validity of DCAA's reported $155 million in excess costs to be incurred by the government during the period 1981-84, (3) whether increases in engineering labor rates at Pratt and Whitney and at four other contractors were excessive in relation to the increases for government and other private sector employees as reported by BLS, and (4) whether the administrative contracting officers utilized DCAA's findings and recommendations in negotiating forward pricing labor rate agreements. The contractors selected were large companies substantially involved in government work and located in the southeastern part of the United States.

We interviewed administrative contracting officers; DCAA, DCAS and contractor officials; and the resident auditor primarily responsible for the DCAA report. We also determined the extent to which administrative contracting officers utilized the DCAA reports in negotiating forward pricing labor rate agreements at the four other contractors. We did not obtain agency and contractor comments on this report.

We also reviewed (1) DCAA's follow-on April and August 1982 reports on labor rate increases at Pratt and Whitney to determine if they were based on the same rationale and methodology as the March 1982 report, (2) the DCAS report of November 1982 on a compensation study at Pratt and Whitney, and (3) the DAR and the DCAA Audit Manual.

We made our review in accordance with generally accepted government auditing standards.

PREPARED STATEMENT OF WOODROW W. MURPHY

Mr. Chairman and Members of the Committee, I am Woodrow W. Murphy, formerly a GM-13 Supervisory Auditor with the Defense Contract Audit Agency before I retired on December 31, 1982 with thirty years civil service experience.

I am a graduate of Southern Methodist University and have a Bachelor of Science degree in accounting. I began my civil service career with the General Accounting Office where I participated in audits of government agencies and defense contractors. I served with the Internal Revenue Service as a special agent for a short time before joining the Defense Contract Audit Agency. During the period of my employment with DCAA, I directed increasingly complex audits and was promoted to supervisory audit status. Incidently, while working for DCAA I moved my residence and family three times to facilitate the Agency's operations.

The subject of this hearing "Management and Operations of the Defense Contract Audit Agency" has been of special interest to me for many years and I fully support this Committee's objective to find ways to improve the effectiveness of this Agency. I hope my testimony will help you achieve that objective.

As an auditor with GAO I audited Defense contracts at several aircraft plants in the vicinity of Dallas, Texas and at the atomic energy plant at Amarillo.

My work experience with the Defense Contract Audit Agency can be summarized as follows:

- During the first eight years, I served first as the resident auditor at Bell Helicopter in Hurst, Texas, then as the resident auditor at Collins Radio Co. in Dallas, Texas, and then as the resident auditor at the Chance Vought Corporation, Electronic Systems Division plant in Garland, Texas.
- My next assignment was resident auditor at the Hughes Aircraft-Ground Systems Division plant in Fullerton, California where I served for about two years.
- Then I returned to the Agency's office in Dallas where I served as a regional and then Branch supervisory auditor for about eleven years.
- My next assignment, the one I will be discussing in more detail today, was a three year assignment as supervisory auditor at Texas Instruments in Dallas, Texas.
- The last assignment, before my retirement, was supervisory auditor at the Agency's Richardson Branch Office located at

the E Systems' plant in Garland, Texas where I served for about three years.

My experience included many diverse and very complex audits at several defense contractors. Let me mention a few of them.

I audited the claims for equitable contract price adjustments of approximately $156 million filed by Avondale Shipyards. The Navy's claim settlement committee was headed up by Mr. Gordon Rule and Admiral Ken Woodfin. You may recall that this claim was the subject of a hearing before a Committee chaired by Senator Proxmire. Admiral Kidd also testified. Avondale subsequently offered to settle this claim for approximately $85 million.

I audited the claimed costs and testified before the Armed Services Board of Contract Appeals on the Todd Shipyards contract to repair government owned facilities in New Orleans, Louisiana. The findings in this case resulted in a revision to the Defense Acquisition Regulations. I also testified at an ASBCA hearing in connection with a defective pricing audit report on Baldwin-Defense Contracts Division.

In connection with a Baifield Industries' $15 million claim for equitable contract price adjustment, I performed an audit and presented related testimony which resulted in ASBCA decision to award the contractors' only $137 thousand. The U.S. Court of Claims subsequently reduced this award to approximately $37 thousand.

In total I issued eight reports that resulted in ASBCA cases and testified before the Board on five of these cases.

ACCESS TO RECORDS

As a general rule, contract auditors can persuade small Defense contractors to provide unrestricted access to facilities, records and other related data needed to perform the audit mission including, but not limited to, labor attendance and time checks; classification, control and utilization of government furnished special tools and test equipment; and examinations of recorded and projected costs.

The situation is somewhat different, however, with some of the larger contractors. At the Texas Instruments (TI) plant in Dallas, Texas, however, I am personally aware that as early as 1958 Texas Instruments was a most difficult contractor to obtain the records and data required to accomplish the contract audit mission. In commenting on an audit report in 1965, for example, the contractor acknowledged to the Navy that "...Time after time throughout this report it is mentioned that we did not give the auditors access to cost data on fixed price contracts. This statement is true...." At TI, I encountered many long delays before I received responses to my requests for accounting records, and in my judgement long delays mean denial of access. At TI I was denied access to both property and incurred cost records. The situation was so bad in 1979 that one DCAA Regional Audit Manager wanted to issue a disclaimer against TI's accounting system and estimating system report.

In order to resolve the problem created by the inadequacies in the contractor's submissions, I notified the contractor in writing so that he would have an accurate understanding of the nature and extent of the inadequacies. With the concurrence of the Resident Auditor, a copy of my letter was sent to the Procuring Contracting Officer pursuant to the requirements in the Defense Acquisition Regulations (3-801.5(f)(10)). In response to my letters, the contractor told me that if I didn't stop sending copies of the letters to the Contracting Officer he would get me transferred. He later carried out this threat.

Texas Instruments' officials complained to the DCAA Resident Auditor and to the Atlanta Regional Manager and other regional supervisors.

Toward the end of my tour of duty at TI, the "Access to Records" problem still wasn't resolved even though TI had promised to allow more access to records. At the conclusion of one meeting to obtain greater access, the resident auditor noted that he had heard this promise many times before and expressed the opinion that he was skeptical whether TI would comply.

ACCESS TO FACILITIES

We even had trouble gaining physical access to production lines and government-owned facilities. Based on a study we were performing on government property, I suspected that the Defense Department might be wasting millions of dollars at TI by providing funds for special tools and test equipment without identifying the specific items to be provided or the functions to be performed by them. For example, on an M-1 Tank Thermal Sight contract, the government provided over $5 million for special tools and test equipment. Like me, some Defense Contract Administration Service personnel at TI were also concerned that TI had purchased standard off-the-shelf industrial tools and test equipment (such as milling machines, oscilloscopes, etc.), classified them as special tools and equipment, and was paid for them under the contract. In this case, DCAA could have issued a Notice of Cost Exception suspending or questioning these costs. Instead, the Regional Audit Manager closed out the study on the premise we did not have the expertise to make such a determination.

As far as I know there was still an 'Access to Records and Facilities' problem at Texas Instruments when I retired on

December 31, 1982 - restrictions on the DCAA auditors access for over 25 years. As a result, the scope of many DCAA audits at that location were limited, auditors conclusions had to be qualified, and audit recommendations were incomplete and less helpful to government procurement and contract administration officials. The ultimate impact of Texas Instruments' denial of access to records and facilities was to place the government's contracting officers in a very unfavorable bargaining position when negotiating prices on the many sole source contracts awarded to Texas Instruments.

I understand that, as a result of the attention drawn to the 'Access to Records' problems at Pratt-Whitney during the Merit System Protection Board investigations in the "Spanton case" and inquiries by your Committee's investigators and the DoD Inspector General's staff regarding TI, DCAA officials met with the TI comptroller and the resident government contract administrator in December 1983 to resolve the longstanding 'Access to Records' problem at TI.

However, just last week I learned that your investigators found that as recently as January 1984, government officials at Texas Instruments were still apologizing to Procuring Contracting Officers for providing extremely limited cost analyses in support of contract negotiations - the reason, as usual, was restrictions in access to the TI records that supported TI's pricing proposals.

Due largely to my persistent efforts to gain access to the TI accounting records and production facilities necessary to conduct my audit work, I eventually found myself in the same position as Mr. Spanton. The contractor had complained about my aggressiveness to DCAA officials. As a result, I was given three options: (1) a permanent change of duty station requiring me to move my residence and family, (2) retire, or (3) be fired because as I was told, officials of Texas Instruments believed I caused most of their interface problems with the procuring office and DCAA. TI complained that they had difficulty getting along with me.

During my assignment at TI, I suffered my first serious coronary sickness, and in the recovery process I had to use much of the 2,000 hours of sick leave I had accumulated during the course of my career.

After I was transferred from the TI residency to the Richardson Branch Office, I again suffered a severe coronary attack. The Atlanta Region felt I was cheating on the system and notified me, through the Regional Audit Manager that he was going to order me to take a 'fitness for duty' examination. They ordered the exam, and it cost the government over $2,000. In January, 1981, I had a pacemaker implanted. I saw that the continued administrative pressure coupled with the constant adversarial nature of my job was taking a toll on my health. At the insistance of my son, who is a medical doctor, and my family doctor, I chose one of the three options previously offered me by DCAA. I retired.

Before closing, I would like to mention three personnel management practices in the Defense Contract Audit Agency that I found particularly harmful:

1. The use of the Bell curve by the Atlantic region to rate supervisory audit personnel was one of the most demoralizing and grossly unjust practices I witnessed during my thirty years experience with the government. The requirement to achieve a symetrical distribution of performance ratings precluded the realistic rating of each auditor. I have reason to believe this practice continues.

2. The practice of arbitrarily rotating senior auditors every five years was unnecessarily costly to the government in terms of both money and reduced efficiency. This is particularly true for auditors who are approaching retirement, such as Mr. Spanton and I were when we were threatened with transfers. I might add that I know of other auditors currently employed by DCAA who feel the same way I do, but won't testify for fear of punitive actions by DCAA officials.

3. Incentive performance pay should not be based on Agency-wide man-hour standards. One can't legitimately evaluate an auditors' performance at TI where there is an access to records problem on the same basis as an auditor's performance on a similar assignment at E Systems where access to records is not a problem.

In conclusion, I believe the efficiency of the Defense Contract Audit Agency can be enhanced by the following changes in practices:

1. Stop the practice of taking auditors off assignments because of contractor complaints, unless it can be demonstrated that the auditors' practice is or has been unprofessional. Based on my discussions with other auditors this fear of punitive transfer has a significant adverse impact on the their professional independence. Even the Regional Audit Manager complained to me that the auditors at Texas Instruments did not press for access to records.

2. Insist that Defense Department Procuring Contracting Officers and Administrative Contracting Officers assure that contractors' pricing proposals and other submissions are complete and adequately supported and that DCAA auditors are

granted the necessary access to contractors' records and facilities.

3. Assure the contract auditor's organizational and personal independence by making the Defense Contract Audit Agency a part of the DoD Investigator General organization. This action would eliminate the 'Access to Records' problems because the Inspector General can subpoena the records.

4. Increase the amount of effort applied to audits of government property in the possession of contractors. Audits of government furnished property currently receive a very low priority by DCAA auditors partly because they are not able to report dollars audited and saved on these audit assignments. I recommend that the DoD Inspector General, with the assistance of the contract auditors, be required to perform periodic audits of special tools and test equipment and other government property in the possession of Defense contractors.

Mr. Chairman, this concludes my prepared statement. I will be pleased to answer any questions you wish to ask.

Chairman Roth. At this time, before we close the hearing, I would offer the opportunity to either Mr. Sherick or Mr. Starrett if you want to respond or reply to the testimony given subsequently.

Do you care to, Mr. Starrett?

Mr. Starrett. Right now?

Chairman Roth. Do you care to make any further statement at this time?

Mr. Starrett. I would like to make a couple of comments, yes. I believe they are in order here.

One of the things that has been mentioned here, particularly——

Chairman Roth. I think it would be better if we would excuse the three gentlemen and if you care to comment, if you could come forward.

Mr. Starrett. Thank you. Thank you.

Chairman Roth. Mr. Sherick, the same invitation is extended to you.

Mr. Sherick. I don't have anything.

Mr. Starrett. The matter came up by Mr. Spanton's comments with regard to a resident auditor at a location in Texas, General Dynamics, Fort Worth, that the fact that the auditor resigned. That auditor did resign. Mr. Spanton is correct on that. Mr. Sanchez at that location has a business of his own on the side, and it has recently flourished considerably, and he decided that he was going to spend full time involved in that business. We also have—that is a good example of the rotation program within the Defense Contract Audit Agency that Mr. Spanton and Mr. Murphy do not like and I know very few people who do like that program. You do have to move every now and then, but we moved the resident auditor that had been in General Dynamics, Fort Worth, after about 6 years.

As soon as we moved that resident auditor and we put Mr. Sanchez in there, he went in with a fresh look, a new way of doing the audit, and he asked for the whole general ledger at one time. Prior to that, evidently, we had been asking for an account, and was shown, but never asked, evidently, for the whole general ledger before. General Dynamics said no. We currently have over $10 million of General Dynamics' money right now with form 1. The company is having a meeting today at the corporate level. I do not understand this position by General Dynamics, but they are going to decide what it is they are going to do. The Air Force is going to join us tomorrow, and they are going to withdraw or not make any more progress payments related to the fixed price type contracts at General Dynamics if we do not get access.

I think that sets that record straight as far as Mr. Sanchez is concerned.

Chairman Roth. Let me just make two observations. First, I understand that DCAA had a somewhat limiting company-wide access to records understanding with General Dynamics Corporation since 1973—an understanding that was arranged and agreed to by GD officials in the corporate office in St. Louis and DCAA headquarters and regional officials. Second, I notice you said that you permitted the former resident auditor at General Dynamics to stay at that location for over 6 years. Of course, should we give Mr. Sanchez the recently assigned and more recently resigned resident auditor an opportunity to comment on the matter himself.

Mr. **Starrett**. Fine.

Chairman **Roth**.With respect to the withholding of payments, and I'm not commenting on the specific incidents because I don't have the facts before me, our problem, frankly, is why now and why not before? There have been some complaints about two contractors, as previously referred to who did not provide adequate access to information. I'm glad to see that some action is being taken now, but in all candor, I wonder if this is a single show of action or whether it portrays future conduct. We will be watching very carefully. In my opinion, your agency, from the management standpoint, has not been vigorous, has not enforced what has been the intent of the law, has not done the kind of job that I think is essential to protect the interest of the taxpayer.

Now, if you are changing your policies and doing something about it, I may well, in the future, congratulate you. But I think it is critically important that until we make greater use of competition, which is, of course, the first requirement, we must have adequate auditing which means that we should have the necessary access to contractors' records. If you do not have access, then the contracting officer should not be proceeding.

So I am pleased to hear that you are beginning to take some action and would hope that this means a change.

Senator Levin.

Senator **Levin**. Mr. Starrett, we have heard this morning from a number of people that there is pressure on auditors not to make too many waves, not to ruffle feathers, not to try to find ways other than stopping payment: form 1. What is your policy when a company has a complaint with an auditor, that that auditor is asking for too much? Is the company told that they must put a complaint in writing and go through a certain process? Are oral complaints to auditors 'supervisors and people higher up the chain received by those people? What is the process?

Mr. **Starrett**. We don't have a specific process for that, but we have a number of contractors that complain all the time about defense contract auditors that are overly aggressive, that they are looking into too many things and doing too many things. Some say "There is no need to do this audit."

Operations audit is one thing we get challenged on frequently. There are several ways that we go about taking care of that problem. One of them is a high level meeting with the management of the company by high level people within the Defense Contract Audit Agency. With that up-the-chain-of-command type of thing, we will usually be able to resolve the problem. We have no problem with aggressive, tough auditors.

I must point out that when Mr. Spanton talks, he never had a problem as far as getting access. He has always been able to use the tools. Mr. Sanchez is a very highly rated auditor at General Dynamics. At the other location of Pratt & Whitney, we had a fellow there by the name of Thomas Potter. Thomas Potter has received many awards for his aggressive auditing practices.

Senator **Levin**. Did you give Mr. Spanton some awards for his aggressive auditing?

Mr. **Starrett**. Mr. Spanton's audit he was talking about was the subject of a GAO report issued on February 24, 1984. That GAO report clearly indicates Mr. Spanton's audit report was based on some pretty sketchy bases.

Senator **Levin**. Don't you think it would be useful to have a process, when there is a complaint by the company that the auditor is being too aggressive, so that we have a record as to where that complaint went to? Don't you think we ought to prohibit oral complaints to supervisors from companies when those supervisors are trying to manage contract negotiations. Since there is no stated procedure we don't even know what level of supervision is receiving the complaint.

Mr. **Starrett**. I don't know how we would limit those complaints.

Senator **Levin**. If we have a complaint. We ought to put it in writing and send it to office X.

Mr. **Starrett**. That we could do.

Senator **Levin**. Why not?

Mr. **Starrett**. That we could do.

Senator **Levin**. Because the real problem that we are getting from auditors is that word gets down to them that they are being too aggressive. Let me tell you, that is a real damper on those auditors.

Mr. **Starrett**. I am concerned.

Senator **Levin**. Mr. Batson heard that, too, when he was investigating, and the IG's office has heard that, and apparently you have heard it. Now, the one way to stop it, if you are serious about stopping it, is to tell the companies very civilly, "If you have a complaint about overreaching of overaggressive auditors then you do have a right to object." And by the way, I am sure there are occasions where that happens.

What I am suggesting to you is, if you want to get this thing in hand, get a process for it. The right process is, "Folks, if you have got a complaint with our auditor, put it in writing, send it to such and such an officer, and we will then take care of it in an appropriate way."

Companies need such a right, but by God, auditors are telling us that, word filters down, "You are being too tough," and that has a chilling effect on the auditing function.

Mr. **Starrett**. I think that is an excellent idea.

Senator **Levin**. Let us know what you do with it.

Mr. **Starrett**. I will.

Chairman **Roth**. Thank you.

The committee is in recess, subject to call by the chairman.

[Whereupon, at 1:30 p.m., the committee adjourned, subject to the call of the Chair.]

MANAGEMENT OF THE DEPARTMENT OF DEFENSE

WEDNESDAY, MARCH 7, 1984

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, D.C.

The committee met at 10:05 a.m., in room SD-342, Dirksen Senate Office Building, Hon. William V. Roth, Jr., chairman, presiding.

Present. Senators Roth and Levin.

OPENING STATEMENT OF SENATOR ROTH

Chairman ROTH. The committee will please be in order.

I want to start out by saying that we are here for three purposes today. First of all, as those of you who attended the earlier hearing last week know, I was not satisfied when this committee was notified 10 minutes before its hearing that Mr. Fitzgerald would not be able to testify as an official witness. Much of his statement was very significant on the matter being raised at the hearing and, as I said then, it was important that we have all the witnesses before us to testify on the effectiveness of the DCAA.

Since then, I wrote the Secretary of the Air Force, Mr. Orr, and advised him that I would like to have Mr. Fitzgerald testify as an official witness. However, if that was not possible, I still wanted him, and whomever the Air Force might designate as their official witness, to testify on the matters before the committee.

Subsequently, and I think the letter has been released to the press, Secretary Orr said that while Mr. Fitzgerald would not testify on behalf of the Air Force, he was free to appear before this committee at any time in a private capacity.

We do have today an official witness, General Weiss. Mr. Fitzgerald has chosen not to appear, so far as I know, for personal reasons. While I regret his not being here today, I respect his decision. We do have his statement. It was released last week. I am sure it was read by you, General Weiss, and we shall make reference to it during the hearing this morning.

I want to make two points to you, General. The purpose of these hearings primarily are twofold: One is the question of whether or not DCAA is doing an adequate job as the auditor for the Pentagon. And I want to make it very clear that I think the evidence to date shows that is not the case.

I am not satisfied with the job that DCAA management is doing. I do not believe that it is being the watchdog, as it should be, for the American taxpayer. I am concerned by statements such as the one made by Mr. Starrett to two of my investigators that DCAA auditors are advised to get along with the contractors. That appears to characterize the attitude of much of the top DCAA management. I intend in no way to reflect on the many fine auditors that serve in that agency, but we both know that when management sets the policy those serving under its direction are going to do as they are bid.

I might point out that there are a number of people in high positions within the Air Force who have indicated that they are not satisfied. I have been told and advised that people very high in the Pentagon are interested in bringing about effective procurement.

One of the things I am going to be watching very carefully is to see what steps are taken to insure that DCAA begins to function as is intended.

The second matter which is of grave concern to me, is the question of compensation. When we are talking about compensation, we obviously are not just talking about the wages of blue or white collar workers, but the wages and benefits of workers at all levels. The same is true for the engineers who we all know play a key role in the procurement of new weapon systems.

What I am interested in knowing is whether or not the compensation, including the fringe benefits, is reasonable and fair.

General Weiss, you are purportedly, as far as I know, an expert in this area, and you have submitted a lengthy statement that gives a historical overview of this issue. But let me say that rather than you reading your entire statement, I would like you to know what I am interested in learning, and I want it said in terms that the layman can understand.

Frankly, too often the witnesses come up here with very voluminous, extensive statements about all the studies that are underway and all the great things that are being done, but I am not interested in that. I want to know whether compensation rates for all levels of employees from management on down and including fringe benefits are reasonable.

It does no good to talk in generalities and say, "Well, they are fair and good." This is a situation where we need to know, frankly, what is being done contract by contract.

So I am asking you to summarize what you have to say, and to say it in terms that we who are not experts in the area can understand. Is compensation reasonable, based upon the standards set in the DAR? Are those regulations adequate? If not, what needs to be done to reform them and where do we go from here?

I want to make it very clear that I think there are those in the Department who are trying to do something on this issue, including the Secretary of the Air Force, Mr. Orr, who is concerned about the cost of labor, as well he might be. Even by your own testimony, as I understand it, labor rates account for 70 percent of the cost of procurement. I think Mr. Orr showed his seriousness of purpose when he stated in an April 15, 1982, memorandum: "I am fully prepared to accept work stoppages in some of our weapons acquisition programs if that is what it takes to bring inflation under control and to bring wage settlements to the level which the Government deems adequate for its own people."

But let me say in closing, and then I will ask Senator Levin if he has any opening statements, that I indicated to the Inspector General last week that I expect a careful study to be made to demonstrate whether or not pay is adequate and reasonable. We are not going to be satisfied with talk about what is going to be done, or what studies are going to be made. I want to know very simply where are we now.

[Senator Roth's prepared statement follows:]

PREPARED STATEMENT OF SENATOR ROTH

We convene today to follow-up the oversight hearing the committee held last week concerning the effectiveness of the Defense Contract Audit Agency.

I said during last week's hearing that I was upset that the Air Force refused to allow Mr. Fitzgerald to appear as a witness before our committee in his official capacity as management systems deputy in the Air Force. I said then that I refused to allow anyone, in any Government agency, at anytime to prevent this committee from performing the important oversight work it is responsible for under the rules of the Senate.

I also said that I would immediately ask the Air Force to allow Mr. Fitzgerald to present his views before my committee.

In an effort to assure that the issues surrounding DCAA's performance and increasing compensation rates in Defense contracts are thoroughly reviewed, I requested that the Air Force allow Mr. Fitzgerald to testify in an official capacity. If the Air Force continued to refuse to clear his testimony I then requested Mr. Fitzgerald be able to testify as a private citizen. I also requested that the Air Force send a witness who could explain why the Air Force disagreed with Mr. Fitzgerald's statement so much that they refused to approve it. I believe the issues Mr. Fitzgerald raises in his statement are important and need to be aired. The information I have, however, indicates that he has declined to appear as an individual. I regret that, but I believe the issues he has raised in his testimony need to be reviewed and for that reason I have elected to continue with the hearing.

One of the reasons for my anger was the fact that the committee was not notified until 10 minutes before the hearing was scheduled to begin that Mr. Fitzgerald's statement would not be approved by the Defense Department and that he would only be allowed to appear as a private witness. I have asked the IG in Defense to find out who refused to approve Mr. Fitzgerald's statement and who decided that he should not be allowed to testify in his official capacity.

I would also point out that the 1982 court order reinstating Mr. Fitzgerald in his current position gives him the authority and the policy control over a broad range of matters including cost control. It seems to me the issues we are considering today would fall under the category of cost control and I want to know why he has not been allowed to give this committee his views as an official Air Force representative. Mr. Fitzgerald is the management systems deputy in the Air Force but the Air Force would not permit him to report on his observations in that official capacity today.

This hearing is actually a continuation of an oversight hearing on the effectiveness of the Defense Contract Audit Agency the committee held last week. Let's just say that based on the evidence we heard last week, I am very dissatisfied with the ineffectiveness of DCAA's management. It seems to me that the unwillingness of DCAA management to press hard for contractor records needed to complete audits and its apparent concern with its relationship to the "acquisition community" has left it with little of the backbone it needs to fulfill its duty as the front line of defense against needless waste and overpricing.

Some of the evidence we have before us today also indicates that DCAA may not be as effective in its watchdog role as it should be. For example, DCAA conducted an audit, at the request of the Defense IG, of labor distribution and time card problems at the Hughes aircraft plant in Tucson, Ariz. Despite numerous indications of potential problems with labor distribution at the Hughes plant, that my investigators found in DCAA's own files, the agency concluded that the contractor's internal controls over timekeeping and labor distribution were adequate.

In another case, former Assistant Secretary of the Air Force Russ Hale asked DCAA to review its files to determine what information it had gathered on labor rates. The DCAA's response was so unhelpful that the Assistant Secretary wrote to the comptroller of the Defense Department through whom the DCAA director reports, and asked whether or not DCAA was "playing on the same team." He also noted the DCAA "could be considerably more helpful" than they were in assisting the Assistant Secretary. Mr. Hale was attempting to review the serious problem of increasing compensation rates in the aerospace industry and DCAA apparently failed to be as helpful as they could. That should not happen and I want to know more about this matter.

Another issue the committee will be examining today, compensation rates and labor distribution in Government contracts with aerospace firms, is extremely important. Although it sounds complicated, what we are really talking about is an important part of the costs incurred by the Government on its contracts. Essentially, we want to find out whether compensation rates, the charges made by contractors for labor and fringe benefits, and the way these charges are allocated on Government contracts are unnecessaily high in the aerospace industry. If these rates are too high, they could be an important factor in the cost growth which affects most of our major weapon systems.

I would just point out here that we are not focusing our primary attention on labor costs. We are talking about total compensation packages proposed by Government contractors, including the salaries and benefits paid to executives and highly skilled technical people. Some of the evidence indicates that compensation rates for these executives and skilled technicians may be much higher in aerospace firms contracting with the Government than the compensation rates of personnel at similar levels in other industries. We want to find out if this is true and if it is, what is being done about it by the Government.

There is little incentive for Government contractors operating a negotiated cost type or fixed price contract to hold down labor hours or compensation rates. As a practical matter, if the entire effort of a plant is devoted to production for the Government and there is no credible, ongoing threat of the Government taking its business elsewhere, it could seem the incentive is actually for the contractor to allow compensation costs to increase. Real competition could keep such increases in check but unfortunately competition is an all too rare thing in Defense Department contracting.

As a result, we must have good auditioning and firm negotiating in order to insure that compensation rates for Government contracts do not increase out of line with similar increases in the private sector. Recent evidence indicates this may in fact be happening. A study by the directorate of management in the Air Force, for example, shows that by May of 1982, aerospace compensation rates had reached a level 44 percent above other manufacturing and 39 percent above durable goods industries in the Bureau of Labor Statistics categories. An audit of one contractor in the Southwest found that we may be paying up to 17 times as much as we should for labor at that particular location. If these initial findings are any indication, compensation rates could be a significant contributor to cost growth in our weapons programs.

It's not just compensation rates that concern us today. Some evidence indicates that contractors are failing to allocate their labor costs accurately to Government contracts. In some cases, mischarging or even cross charging has occurred and the Government may be asked to pay for work on a contract that was never performed. My committee investigators reviewed evidence that this may be occurring at one contractor's plant in the Southwest and 2 years ago, investigators from my Permanent Subcommitte on Investigations saw similar evidence at a Navy contractor's plant. Further, during the 3 year period between late 1978 and March 1983, DCAA had referred 59 cases of possible labor mischarging to investigative agencies for review. We want to examine this matter today as well as determine how extensive the problem is and what the Government is doing about it.

I believe Air Force officials are aware of this problem and I know Secretary Orr has taken some initiatives in this regard. I think the problem is serious, however, and it may be occurring in Navy and Army programs as well. We can't determine that today it is a matter I have asked the Defense IG to review.

Cost growth in weapons programs is a serious problem which has been around for decades. It is a complex problem made up of many parts including factors such as material costs, inflation, changes in schedules and underestimating of program costs. Compensation rates are one of the important factors in the cost growth problem that we want to examine in depth today.

Chairman Roth. Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you, Mr. Chairman. Before we get to this witness, Mr. Chairman, I am wondering if we can resolve an issue that still remains in my mind at least relative to the appearance of Mr. Fitzgerald before this committee. I had understood last week that he was going to appear. He had been invited to appear. Some of us made statements last week when he didn't show up that we were not about to accept stonewalling from the DOD on this issue, and it was our assumption, as it turned out apparently a false assumption, that it was the DOD or the Air Force that had muzzled Mr. Fitzgerald. It turns out, apparently, he has muzzled himself, at least according to a letter I received from General James P. McCarthy, Director of Legislative Liaison for the Air Force, which I would like to make a part of the record.

[The letter referred to follows:]

DEPARTMENT OF THE AIR FORCE,
Washington, D.C., March 2, 1984.

Hon. CARL LEVIN,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LEVIN: It has come to my attention that Mr. A. Ernest Fitzgerald, Deputy Assistant Secretary of the Air Force (Management Systems), was not present at the hearing of the Governmental Affairs Committee on March 1, 1984, concerning oversight of the Defense Contract Audit Agency. I also understand that Chairman Roth and a number of Committee members expressed concern that the Air Force had objected to Mr. Fitzgerald's appearance before the Committee and prevented him from testifying before the committee.

Nothing could be further from the truth.

In personal conversation with Mr. Fitzgerald on February 29, 1984, the Secretary of the Air Force urged Mr. Fitzgerald to appear before the Committee and to make any statement he felt appropriate. Mr. Fitzgerald was also informed, both orally and in writing, prior to the hearing, that he was free to testify. He was also informed that Secretary Orr recommended that he testify and encouraged him to do so.

Mr. Fitzgerald's decision not to appear before the Committee was his and his alone.

We have stressed to Mr. Fitzgerald that it is not necessary for him to clear his statements with Air Force personnel so long as he makes it clear to the Committee that he is speaking as an individual and not speaking on behalf of the Air Force.

As far as the Air Force is concerned, Mr. Fitzgerald continues to be available for appearances before Congressional Committees at any time desired.

Sincerely,

JAMES P. MCCARTHY,
Major General, USAF, Director, Legislative Liaison.

Senator LEVIN. It is a clear statement of the Air Force that if Mr. Fitzgerald wanted to come before the committee, he was free to do so. He would not be there as an official representative of the Air Force, but he was free to come before the committee, and they in no way told him he could not come as a private citizen.

I, now having heard from the Air Force, assume that now being the fact, we now have a situation that it is not the DOD or Air Force that has muzzled Mr. Fitzgerald. Mr. Fitzgerald is declining for personal reasons to appear before the committee.

If his testimony is useful to this committee, and I presume it is or else we wouldn't have invited him in the first place, I think we ought to get him here. I now personally feel that my assumption that the DOD or the Air Force was the source of Mr. Fitzgerald not appearing last week was inaccurate, I do not feel comfortable just sitting here not having Mr. Fitzgerald here. I am wondering whether the Chair is just simply now going to say, "OK, if he doesn't want to appear that is it," or do we want to say "He has information we want to hear, let's get him here?"

Chairman ROTH. As I said prior to your being here, Senator Levin, at this stage, I am willing to respect his desire not to be here because I wanted to hear him. I would have preferred it if he had appeared to express his views of the relative effectiveness of DCAA and employee compensation in the aerospace industry based on his experiences as the Air Forces Management Systems Deputy, but he has elected not to testify as a private citizen, as I gather, for personal reasons. I have no information, either from him or anyone else, that there is any reason, directly or indirectly, that he cannot appear, but this is a matter I will be glad to take under advisement.

Senator LEVIN. I would, as one member of the committee—there may be personal matters here that are legitimate, but in the absence of some statement as to what those personal reasons are, I think a Senate committee has a right to hear from an employee of the Government we want to hear from. Mr. Fitzgerald is an employee of the Government. He obviously has some information we thought was useful. We jumped to the wrong conclusion last week, and I apologize for participating in the assumption that it was somehow the DOD.

I assumed the reason he wasn't here was the DOD or Air Force had muzzled him. Apparently, what they told him was that they would not approve his testimony, therefore he could not represent them officially. I am not critical of the Air Force and the DOD for saying they don't approve his testimony if they don't approve his testimony. They do have that right. I think we should insist Mr. Fitzgerald be here for testimony we think is relevant. The principle is important, and I don't think he ought to decide whether or not he shows up; I think we ought to decide whether or not he shows up. Once he is invited, presumably because he has important information for this committee, I think we ought to then decide whether or not we are going to let him uninvite himself.

Again, I say this without any reflection at all on the Department of Defense and the Air Force; in fact, quite the opposite. I think I made it clear already what I said, they acted in their rights in saying he is not representing them in his testimony.

I am not in any way saying DOD or the Air Force was in error. They acted within their rights and I would defend that, but I think we should act within our rights in terms of getting him here.

As one member of the committee who feels strongly, unless there is some satisfactory explanation beyond personal reasons for not wanting to appear, we ought to get Mr. Fitzgerald here and we ought to hear what he has to say and add it to our hearing record. I think it is an important matter of principle, Mr. Chairman, perhaps more important than the substance we might be hearing here this morning, although I don't want to denigrate that because we might be hearing something critically important.

I think that a Senate committee wanting to hear from a particular employee of the Government, and having that person say he doesn't want to appear for personal reasons, is a critical principle that we should insist upon.

Chairman **Roth**. As I said earlier, I am not personally satisfied with what the Pentagon did last week. I agree with you, they have the absolute right to decide who officially represents them. However, I do think as chairman of this committee I am entitled to information prior to 10 minutes before the hearing begins, particularly when it is a key witness. Frankly, while I agree with you that we certainly have the right to have the witnesses which we request appear before us, the matter I am most concerned with, because there is no question about our authority and power to bring Mr. Fitzgerald or anyone else before the committee, is the substance of these hearings, much more so than this procedural question. I will take it under advisement.

Senator **Levin**. Thank you, Mr. Chairman.

Chairman **Roth**. But as I said, the real purpose of these hearings is to find out whether or not DCAA is doing an adequate job.

Why do I attach such importance to that matter? Well, as I said at the last hearing, when you don't have competition, the principal basis for insuring fair contract negotiations is to have financial information that is accurate. If the DCAA is not doing an adequate job of securing that kind of information, then negotiations, for all we know, could be overpriced. This is a matter of real concern to me and one that, in addition to the question of compensation, I shall continue to pursue.

Why don't we proceed, General Weiss. I would ask you to summarize your remarks. Your full statement will be included in the record. I want to underscore the need for you to state your case in plain terms so that everybody knows exactly where we are and where we are going.

TESTIMONY OF BRIG. GEN. BERNARD L. WEISS, DIRECTOR, CONTRACTING AND MANUFACTURING POLICY, HEADQUARTERS U.S. AIR FORCE

General **Weiss**. Thank you, Mr. Chairman. I am honored to have the opportunity to be here today to address these two very complex issues and extremely important issues, that of employee compensation, governing not only salaries, wages, and fringe benefits, and the issue of labor distribution to include productivity improvements of defense contractors.

I am the Director of Contracting and Manufacturing on the Headquarters USAF staff and, as such, I am responsible for policy formation and its dissemination to all the Air Force activities.

I would like to just take a minute to describe who in the organizations have responsibility for these two critical areas, the area of compensation and the area of productivity and labor distribution.

If you want to take a simple view of dividing the Air Force up, you would look first at Air Force Systems Command, which is at Andrews Air Force Base, which is concerned with the research, development and test and evaluation of new weapons systems and major modifications to existing ones. They are responsible through the product division, such as the Aeronautical Systems Division, Space Division, and others to acquire through the system program offices that we have these new systems and subsystems.

There the procurement contracting officer function negotiates new contracts. Very important in that function is the role of the Air Force Contract Management Division at Kirkland Air Force Base in Albuquerque, N. Mex. Under them are 24 distinct Air Force plant representatives that administer Air Force contracts, Army, Navy, and other programs, including those of NASA, but the Air Force is cognizant of those facilities. It is in those facilities that you do look at the issues of compensation and the issues of productivity improvement. That is not to say that the procurement contracting officer function and the function of the system program office isn't important.

The other two divisions in my more simple approach of dividing the Air Force is the Air Force Logistics Command at Wright Patterson Air Force Base which is concerned for contracting for logistics support of existing weapons systems and then the activities that are in the major air commands, such as SAC, Strategic Air Command, the U.S. air forces in Europe that are concerned with support to the bases and camps and installations that are under their responsibility.

All told, in fiscal year 1983, we obligated on Air Force contracts $41 billion covering 4.8 million contract actions, to kind of give you a very broad perspective.

Chairman ROTH. General Weiss, I am familiar with the dimensions of the problem, and I know something about the organization. What I am really interested in is getting down to the question of whether compensation is reasonable under the Air Force contracts. Where are we now? Are you satisfied that we are paying reasonable stakes under the rules and regulations? If you are not satisfied, why aren't you satisfied? Do we have adequate access to the records that are necessary to insure that pay is reasonable at all levels? I am interested in any initiatives that you are taking to insure that, but time is going on and I really want to keep to the purpose of these hearings. To put it simply, is compensation reasonable? What is your answer to that?

General WEISS. Really, to answer that question, Mr. Chairman, I have to give you just a short kind of history of where we have come from in the issue of compensation.

Chairman ROTH. I ask you to summarize that very quickly.

General WEISS. I surely will. The two basic regulatory statements with regard to compensation, and the one tends to balance the other, the first one in the defense acquisition regulation, section 12, says that the Department of Defense will maintain a position of neutrality as employees and employers deal with establishing wages, salaries, and fringe benefits. I am sure you could trace that back to labor legislation back in the 1930's and 1940's.

The second major tenet of how you determine whether compensation is reasonable is the cost principles in section 15 of, again, the defense acquisition regulation, and basically in the cost principle, you have guidance to our contracting officers, our auditors, and the other people engaged in the process, to help them make those kinds of decisions.

If you want to summarize what the guidance is, it says that principle requires that total compensation be reasonable in comparison to the total compensation paid by other firms in the same size, in the same industry, or in the same geographical area for the same services or similar services.

Chairman ROTH. Let's stop right there. That, I think, reflects language in the DAR as well; correct?

General WEISS. Yes, sir.

Chairman ROTH. Do you consider that an adequate guideline and what does it mean? For example, let me ask you a further question. It says, "In the same industry." Do you think it is adequate to compare the compensation of one aerospace industry with another or does that give you any problems?

General WEISS. Since 1978, Mr. Chairman, we have worked very hard to change the guidance or to add to the guidance. We do feel the guidance inadequate.

Chairman ROTH. It is inadequate?

General WEISS. It is inadequate, yes, sir. In 1978, we implemented the Air Force spearhead and I must say this, with the Defense Contract Audit Agency, in concert with them, actions to strengthen the existing legislation, in March 1983, 5 years later, the modifications to that guidance came about, were published in the defense acquisition regulation which had succeeded——

Chairman ROTH. Do you think 5 years is a reasonable period of time?

General WEISS. No, sir, it is not a reasonable period of time.

Chairman ROTH. Are you satisfied with the regulations now?

General WEISS. No, we still have problems with the regulations now. Let me explain what happened and what changes we were looking for. We were basically concerned with having the right to question the reasonableness of elements of compensation system, such as not just the hourly wage or the salaries, but also looking at the fringe benefits, the health care costs, the vacations, incentive payments and bonuses.

Well, we did get that authority in the regulatory change that came out in March 1983.

Chairman ROTH. Let me ask you a question there. What you are really talking about is fringe benefits; isn't that right?

General WEISS. I am talking about all elements of compensation.

Chairman ROTH. Wait a minute, you said that you were concerned that under the regulations you were not able to deal effectively with health programs.

General WEISS. We were not effectively able to deal with elements of the total compensation——

Chairman ROTH. What elements?

General WEISS. Such as wages, salaries, and fringe benefits.

Chairman ROTH. What do you mean you couldn't deal effectively? Did you not have the power from the Congress?

General WEISS. The original guidance in the defense acquisition regulation required us to look at the total package of compensation and say whether the total package was reasonable or unreasonable and not distinguish between the elements in that package.

The modification that was just given to us in March 1983 now allows us to question individual elements of that compensation package.

Chairman ROTH. Let me pursue that question. Let me say, I think you should have the authority to look into individual elements, but isn't the key question as far as the Government is concerned, that the overall compensation for each level of employees be reasonable in its entirety? Are you particularly concerned whether one company might pay a little more in health benefits and another one in some kind of, let's say, stock-sharing program, or is it the total package that is your principal concern?

General WEISS. The principal concern is the total package, but to understand the total package, you need an opportunity to understand——

Chairman ROTH. I used to have a little to do with Government contracts a few years ago.

General WEISS. I understand.

Chairman ROTH. Quite a few years ago, and, by God, they had and should have had the right to look at each element. When did this idea creep in that you couldn't look at the individual elements?

General WEISS. As far as I can remember, in my involvement in this business, it has been part of that regulation, the procurement regulations, since I came on active duty.

Chairman ROTH. You are saying now you have that authority?

General WEISS. We now have the authority.

Chairman ROTH. But it is still not adequate. Where is it not adequate now?

General WEISS. The burden of proof with regard to the reasonableness of a compensation package still rests with the Government. That is the first problem we have.

Chairman ROTH. I agree with you that that raises a very substantial question, but who says the burden of proof is with you?

General WEISS. The interpretation and the language in the cost principles dealing with compensation.

Chairman ROTH. Is that in the DAR or in any other regulation?

General WEISS. That is contained in the DAR and in many court cases and cases before the Armed Services Board of Contract Appeals. You are aware, I am sure, there is a legislative, a decision history of cases before the Board of Contract Appeals and in some cases before the courts which provide the basis for actions by Air Force contracting officers today. What we have been trying to do——

Chairman ROTH. Let me ask you this question. As a matter of negotiation, is there anything in those hearings that prevent you from incorporating that right into contracts or were they interpreting a specific contract?

General WEISS. No, the contracts reference these cost principles as the basis for negotiation of costs and as the basis for settlement of any repricing of those contracts.

Chairman ROTH. I understand. What I am saying is that the Department of Defense has the authority to modify those regulations so that it would raise a new issue. What I am suggesting is that you could either by changing the regulations or by modifying the contracts, perhaps have a different outcome; is that correct?

General WEISS. Yes, sir; changing the regulation is the approach to do it. You cannot do it individually by contract.

I think I can clarify it a little bit further——

Chairman ROTH. I don't want to get bogged down——

General **Weiss**. I don't want to get you bogged down, Mr. Chairman. One of the other things that we feel doesn't give us adequate leverage in the area of determining the fairness and reasonableness of compensation costs under Government contracts is the sentence I alluded to before in the same industry, in the same size and in the same area. That has been interpreted by the Armed Services Board of Contract Appeals to be what we would refer to as a listing of alternatives and I as a contracting officer in negotiating with a company, that company would take the position that if they make the test of the same industry, they can provide examples of paying the same compensation-type system as another company in the same industry, that they have met the test of reasonableness.

If they could show that there was a company of the same size, that they could prove, in their position, that that met the test of reasonableness.

In the last 15 to 20 years, they have argued those cases before the Board of Contract Appeals and have won, have generally won.

Chairman **Roth**. I understand what you are saying.

General **Weiss**. We are trying to, if I can just finish the thought, sir, and it is a matter of coincidence, we have been working on alternate change to the defense acquisition regulations which will provide us the authority to look at that series of same industries, same size, local area as a series of cumulative guides to determining whether a compensation——

Chairman **Roth**. Exactly where are you? Have any regulations actually been proposed yet?

General **Weiss**. Yes, sir, we have—the Air Force—chaired the Compensation Cost Principle Panel within the Department of Defense. It is an individual who works for me because we feel so strongly about this, I have dedicated resources to do that job. We have been working with the various other service members, the audit staff and Defense Logistics Agency, to come up with the words. We have the words in and by our own procedures, we have had to go to industry for comment. You can imagine that industry is somewhat upset with us about the new modifications to DAR which allow us to look at elements of compensation.

The words we have gotten back in the last 2 weeks about trying to use the cumulative effect of what you look at when you compare one company to another, they are even more concerned about it.

Today that case, with the cognizance of industry, is being submitted to the Defense Acquisition Regulatory Council in the Office of the Secretary of Defense.

Chairman **Roth**. I would appreciate it if you would submit the proposed language. I would also like to know what you think the timetable is. Of course, you have to go out and get comments, and I understand that.

[The information follows:]

The proposed language is provided.[1] This language was submitted to the Defense Acquisition Regulation Council on March 17, 1984. We expect them to take action on our proposal sometime within the current calendar year.

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[1] See p. 295.

Chairman ROTH. I don't want to beat on the Air Force, because I think some within management over there are the most zealous in trying to bring about reform. I compliment the Secretary and Mr. Hale, as well as others, for those initiatives. We cannot wait another 3 years. We have to see some progress being made.

I want to go back to the question I raised earlier. One of my concerns—and I would like to have you comment on this—is that if you merely compare the compenstion rates among Government contractors, particularly those in the aerospace industry, you don't have the competition to keep market forces at play on compensation.

I want to make it very clear that we are not suggesting that people who work under Government contracts should not be paid as well as other people in the private sector. The problem is if you are comparing one Government contractor with another, there is little incentive to keep wage rates down because if they are reimbursed by the Government, they don't really care.

It is not a question if you are dealing with a company that has a large commercial business and their labor costs get out of hand, they can't compete.

Is it adequate to compare Government contractors with each other where their work is essentially with the Government and not commercially as well? What is your position?

General WEISS. My trying to get the changes that I just talked about to the DAR, we want to be able to compare more broadly. We do attempt in our labor compensation reviews to try to make the broadest comparison possible. People have made statements that when you compare the aerospace industry to durable goods manufacturers or you compare the aerospace industry to all manufacturing using the Department of Labor statistics, that the aerospace industry increases have been higher than other industries, other groups of industries. I think that you have to understand that. I am concerned and Mr. Orr is concerned, he probably has been more aggressive in this area than any other Secretary of the Air Force I worked with or know in the history of the Air Force, that it is hard to compare these averages.

When you compare all durable goods manufacturers, only 10 percent of those durable goods manufacturers have employees in excess of 100. In the aerospace industry, we tend to have many large employers. What I am saying is if you look at an average for durable goods or all manufacturing, you are looking at an average that is somewhat distorted because it includes small companies with very small numbers of employees and small firms, and so the aerospace wages, though I really feel they have risen fast and we don't have the leverage to control that in our negotiation process——

Chairman ROTH. Let me go to a statement in your testimony. I think it is on page 6.

> In August 1981, AFSC performed a study comparing the compensation levels of defense contractors and commercial firms. We found that compensation levels were approximately equal for firms of the same size regardless of whether they were commercial or defense contractors.

Is that your position?

General Weiss. Sir, I was the Deputy Chief of Staff for Contract and Manufacturing Air Force Systems Command when we did that study. I asked that that study be done. The study was done at the chief executive officer level and then through correlation, we looked at other managers in these various companies, companies with both defense business, some defense business and no defense business. What we found was that there was no correlation between having 100 percent defense business or substantial defense business and the salaries of the chief executive officers, and by correlation, the managers of those companies——

Chairman Roth. Let me just say, your statement here does not limit, at least I did not read it to be limited to top executive pay. It says, "Performed a study comparing the compensation levels of defense contractors in commercial firms. We found that compensation levels were approximately equal for firms of the same size."

I don't know of anywhere where you modify that along the lines you are now saying, but in any event, this is not what other people are saying, including the Secretary of the Air Force, who has issued a number of memoranda saying that he is concerned.

General Weiss. This was our first study in this effort, sir.

Chairman Roth. You see, that is part of the problem, General. We talk about a 15-year period, your first study. Let me go back again—I realize it is relatively complex and difficult, but it doesn't require much ability to compare compensation for the various plants of the Government contractors with other industry. Certain judgments have to be made, and it isn't exactly simple, I agree with that. But, frankly, if that can't be done in a matter of a few months, contractor by contractor, then there is something wrong with the people responsible for those studies.

It is not that difficult to compare, I don't care whether you are talking about executive compensation or white collar, you compare pay and the fringe benefits. The Government does it every year for their own pay, and apparently can deal with the problem. There may be some questions as to its accuracy, to be candid, but what bothers me, is when you say this has been in existence a number of years and we made a study here. Then you put in your report that compensation is basically the same when that flies in the teeth of what many other people in the Pentagon say causes the problem, namely a lack of confidence, of credibility as to what is being done over there.

Let me ask you this question again. There was a study, I think, begun, what, 14 months ago at DeLauer's request. The Air Force wanted to do it internally. DeLauer asked that it be done for the Pentagon or Defense Department as a whole. That study has been going on 14 months now. I understand the results were supposed to be issued March 1. Where is that study?

General Weiss. The study is in the final process of being completed. There is input coming into the study this month that would give the final information. The report should be coming out early spring.

Chairman Roth. Are you familiar with the study? What is your role in this study?

General Weiss. I was appointed, as a matter of fact, to head up that study effort. When it was originally started and in the process, I moved and I was taken off that study. I am not familiar with the details of the study.

Chairman ROTH. When were you removed, General?

General WEISS. It was in December 1981—I am sorry, December 1982 to February 1983 time because I transferred from Systems Command to Headquarters, but if you look at Dr. DeLauer's letter, my name is in there as the study chief.

Mr. Chairman, I was not able to go through a summary of the total effort, but I think my testimony has specific actions that were taken by the Air Force to contain the allocation of compensation costs to Government contracts. It has never been the Air Force's intent to intercede between management and their employees on any negotiation on compensation, but only to make sure that compensation that was charged the Government contracts was fair and reasonable.

Chairman ROTH. I understand that. I am fully acquainted with that. The fact is that on the issue of compensation rates, the amount that the management pays itself is a decision for that company to determine, but that doesn't get at the heart of the problem.

The heart of the problem is what kind of rates the Government is paying and there we have a vital interest. You have said in your own testimony that 70 percent of the cost of Government procurement is related to compensation.

When I use the term labor, I want to make it clear that I am talking about everyone from top management on down. I am concerned about the rates we are paying both from the standpoint of negotiations of contracts and then reviewing incurred costs.

Let me go back to that statement I just read. We have a 1982 report by the Air Force Comptroller's Directorate of Management Analysis—the Air Force Comptroller's Office, which found the following: Aerospace wages increased faster than inflation. Aerospace wages increasing faster than wages for workers in other manufacturing and durable goods industry.

Aerospace wages higher than those paid for similar services in the local area. Acquisition policy and practices may contribute to inflation in the aerospace industry. Air Force action, jaw boning with industry. I don't want to particularly beat on the Air Force. They at least are trying to do something. Frankly, that flies in the face of your testimony, which I have to say is misleading.

Let me ask you again, you are involved in compensation, that is part of——

General WEISS. From the policy point of view, yes.

Chairman ROTH. Policy point of view. I would like to get back to the basic question. Do you think the Government is or is not overpaying contractors for labor compensation? Are you satisfied with where we are now on the basis of your own experience and knowledge?

General WEISS. Sir, I don't know if I can answer that question because each compensation system of each company that we deal with is different.

Chairman ROTH. Are you familiar with the various contractors?

General WEISS. In a broad sense.

Chairman ROTH. Can you tell me who you are satisfied with and who you are not? I agree with you and feel wholeheartedly that this is the kind of judgment that has to be made on a case-by-case basis.

General WEISS. Mr. Chairman, if, in fact, we have the leverage that I talked about, the additional leverage that I talked about, I feel that we in the Air Force could do a better job in negotiation of compensation systems costs under Air Force contracts.

Chairman ROTH. Are you saying you are not satisfied? You are either satisfied or not satisfied.

General WEISS. I feel that if you compare, and we have seen lots of comparisons and I talked about the durable goods industry, I talk about all manufacturing and the study that you referred to, the DCAA report on the study for OSD and Dr. DeLauer, they even compare aerospace increases to the Consumer Price Index and they don't find that the aerospace increases are in excess of what the Consumer Price Index growth has been.

Chairman ROTH. As a policymaker in a policy position, with respect to compensation, let me ask you this question: What kind of cooperation are we getting from the principal contractors in access to their records on pay? Again, I am talking not only about the blue collar but the more sensitive management and supervisory compensation packages?

General WEISS. It is a mixed bag. We are getting a lot of cooperation from many companies. In certain areas, companies have been unwilling to release to us commercial information.

Chairman ROTH. I am sorry, say that again.

General WEISS. It is a mixed bag. I generally believe from what I have seen that most companies are cooperative. There are certain companies that have difficulty and have refused to release to us information with regard to compensation in their commercial——

Chairman ROTH. How many principal contractors does the Air Force have, private contractors?

General WEISS. We are looking at approximately 22 to 24 that we are cognizant over the Air Force plant representatives.

Chairman ROTH. And what percentage of the Air Force business do they do, would you say, in procurement? How many billions of dollars do they represent, roughly?

General WEISS. Could I just check for a moment. I think I know the number.

Chairman ROTH. Sure.

[Pause.]

General WEISS. We can provide that, sir. Let us doublecheck it.[1]

Chairman ROTH. Please do that, but——

General WEISS. It is a substantial part.

Chairman ROTH. More than half?

General WEISS. No, just about or a little bit under.

Chairman ROTH. How many of those contractors are you fully satisfied with as far as gaining access to their records for all forms of compensation?

General WEISS. We can provide for you the companies we feel we have not gotten data from. There is a reluctance on the part of companies to provide some of the data which deals with their commercial business and that is the area we have problems. With regard to any business or any compensation——

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[1] See response to question number 2, p. 320.

Chairman ROTH. Let's look at that problem. You have a Government contractor that does both Government and commercial business. They ask to be reimbursed under negotiated fixed-price contracts or cost reimbursement for the pro rata share of their executive compensation, isn't that correct?

General WEISS. Well, under fixed-price contracts it is negotiated up front.

Chairman ROTH. But you have to have that information to intelligently negotiate, don't you?

General WEISS. We negotiate compensation systems cost under a program that we call forward pricing rate agreements. We attempt to prospectively negotiate with the contractors what the labor rates, the hourly wages that would be included in the contractor's proposal for labor or compensation costs. Once that is done, then those rates are incorporated into the negotiations.

Chairman ROTH. I don't want to get involved for the moment on projecting future rates. What I would like to know, again, is how many of the prime contractors, and we are talking about the principal ones, are doing the billions of dollars of business with the Government, 22 or 23?

We are not just talking about a minimal amount, but a substantial amount of business that those contractors are doing with the Government, isn't that correct, those 22?

General WEISS. Yes, sir.

Chairman ROTH. How many of those contractors are providing access to all forms of compensation?

General WEISS. I will check that and provide that for you.

Chairman ROTH. Let me ask you, in your earlier testimony and in that statement on page 6, you said that when you were comparing compensation rates on contracts charged to the private sector versus the Government, that it was about the same. You said it was essentially executive pay which you were looking at, is that correct?

General WEISS. Yes, sir.

Chairman ROTH. In that study, did you have access to all the executive pay?

General WEISS. There were one or two companies that we did not have access to.

Chairman ROTH. One or two. So the other 20 is supplying——

General WEISS. Well, we included private sector people and found out in that study that what was driving compensation costs at the executive-type level was not definitely the amount of defense business that they had but the size of the concern, the numbers of people in the concern and the profitability of their company and the amount of sales.

We were attempting to find out if there was a correlation to the executive offices and if the senior people of companies get more money when they have 90-percent Government business than 20-percent Government business and we did not find that to exist at the time we did the study.

Chairman ROTH. I would like you to supply to me the names of those 20 or more companies which are not providing full access to compensation pay.[1]

General WEISS. What I would like to do, because the information we obtained during that study in many cases was competitive, sensitive, and official use only, proprietary, I would like to make that study and the names of those companies available for your staffers at Air Force Systems Command where the study was done. They can actually look at that study.

Chairman ROTH. We will make our investigators available.

General WEISS. I could talk, sir, about the area of labor distribution and productivity, the many actions that we have taken, and we agree with you that where you do not have a competitive marketplace, you must take action to insure that the compensations are correct, and a second way we try to do that is by trying to drive up productivity of the companies that we deal with.

We do that through the use of work measurement, should-cost techniques, where we attempt to determine what an item should cost and not what a contractor says it has cost in the past.

The use of programs that deal with manufacturing technology and technical modification where we are trying to put modern manufacturing techniques into a contractor's facility through his investment and our support. We are doing that, we have done it very effectively at General Dynamics in Fort Worth, Tex., where we do have a very highly automated line. We are using robotics and we are saving considerable dollars, and my testimony reflects that.

We also recently have been able to negotiate a sharing arrangement on sharing the savings that come about from modernization of facilities with Westinghouse Corp. and we feel that is kind of a landmark effort. But when you get down to the bottom line, as you said, the true test of productivity and the true test of reasonable cost is competition.

We are very proud of the efforts on the alternate fighter engine. We are taking efforts to try to extend production as far as possible by two sources so that we maintain the pressures of a competitive environment. We have done this on a program called the ACES II Seat. We have done it on GAU-8 ammunition, and we are looking to do it on many other new programs that are currently in full-scale development.

We feel that is the way that we can keep ourselves and for the taxpayers to protect the interest of the taxpayers and only pay the minimum essential to get the business and services that we need.

Chairman ROTH. I want to congratulate the Air Force for initiating these productivity studies. I think they are critically important. I am concerned with a case involving a major contractor and the DCAA in which the latter was willing to say there were no problems with apportionment of labor costs—let me go to the statement of Mr. Fitzgerald. Are you at all familiar with the Hughes Aircraft Co.'s plant in Tucson, Ariz.?

General WEISS. I am familiar with the work that we have done as an Air Force; yes, sir.

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[1] See response to question number 3, p. 320.

Chairman **Roth**. I assume you saw the statement of Mr. Fitzgerald?

General **Weiss**. Yes, I have seen it. I have it in front of me.

Chairman **Roth**. In connection with this Tucson plant, he points out in his testimony that the Air Force plant representative produced figures for Hughes factory labor performance on their major Government programs at the Tucson plant, which showed labor performance realization ranging from 6 to 50 percent of normal, as measured by the company against its own should take time standards. Does that raise a question in your mind as to the adequacy of their labor performance?

General **Weiss**. It has, sir; absolutely.

Chairman **Roth**. Later, DCAA was asked to make a study of that situation and on February 2, 1983, Mr. Norman Warner, DCAA senior auditor, wrote to Mr. Arthur Gresham, regional audit manager and reported that the risk for labor charging irregularities was minimal. He did not report, according to Mr. Fitzgerald, any observed irregularities as a result of floor checks.

The February 2 memorandum was forwarded on February 22 to the Deputy Assistant Secretary of Defense for Cost and Audit by the Director of DCAA under cover letter in which the Director reported, among other things, that "internal weaknesses were not found." Members of my staff went out to that plant and they found by looking at the work papers of the DCAA auditors—it was not their audit—that of 13 Hughes employees actually questioned, 5 of the 13 did not have their time cards current; 3 of the 13 had signed their time cards in advance, 10 of 13 were using improper correction procedures; 2 of the 13 stated that they performed work on jobs for which they did not have work orders; 9 of the 13 said they estimate or allocate their labor charges to work orders rather than charging the actual time they worked on each work order.

Do you consider that an adequate audit of the labor distribution of that facility?

General **Weiss**. I don't consider the findings of your staffer to be adequate as far as I am concerned with the operation of an industrial facility.

Chairman **Roth**. Let me make the point clear, that was not the work of my staff. That was the work of the Government auditors that they reviewed.

General **Weiss**. Yes, I understand that.

Chairman **Roth**. I misunderstood what you said.

General **Weiss**. I understand. I am not satisfied that somebody could find the errors in time cards that have been reported in Mr. Fitzgerald's testimony. The DCAA is accomplishing another review of the handling of time cards. They are required to do some floor checks. The Air Force plant representative people——

Chairman **Roth**. I will not be critical of you at this point, that is the oldest game in town. The minute we up here on the committee investigate something, either our facts are inadequate or it is under investigation. My point is that, to me, this reflects a lack of aggressiveness.

You go back to that 6 percent, that earlier memorandum that by their own standards they were only working at 6 to 50 percent, that should have been a pretty important signal that they needed to make a careful audit. Would you agree with that?

General WEISS. Well——

Chairman ROTH. I want a yes or no.

General WEISS. I agree that, yes, it should have been a signal to do something. I have got to say this. Back in December 1982, we did a study cause we felt there were lax practices and inefficiencies. It was directed by the air staff to look at these things.

Those deficiencies were reported to Hughes management, culminating several meetings between Mr. Alan Puckett of Hughes, and the Secretary of the Air Force this past fall, which have resulted in the development of a Hughes productivity plant with a status report that has just come out on the first quarter.

We are still concerned with the nature of the progress that is being made in that facility.

Chairman ROTH. Let me ask you, are you aware that DCAA, before it can make a floor check at Hughes Tucson must make advance arrangements?

General WEISS. I am not aware of that, sir.

Chairman ROTH. If that is the case, as I understand it to be, does that provide an adequate audit? What would you do if you were the manager and knew the auditors were coming in?

General WEISS. I don't think the auditors or my people, the Air Force plant rep people should have to provide notice of a floor check.

Chairman ROTH. It makes a mockery of the whole system.

General WEISS. Yes.

Chairman ROTH. Are you aware of the fact——

General WEISS [continuing]. I am not sure that is a true statement.

Chairman ROTH. I understand, but you do agree——

General WEISS [continuing]. If I want to go out on the floor and check what is going on, I am not going to advertise when we go out.

Chairman ROTH. Let me ask you this question: Maybe this is not in the purview of your responsibilities, but is it the general practice for auditors to be required by Government contractors to give prior notice?

General WEISS, It is not general practice to give prior notice prior to performing floor checks.

Chairman ROTH. Let me ask you, going back to the Tucson plant situation, where, as you well know, there have been some accusations made that home box office parts are manufactured on spare time. Are you aware that the DCAA is continuing to refuse repeated Air Force requests for copies of the work papers reviewed by the committee staff?

General WEISS. Could you repeat that, sir?

Chairman ROTH. According to Mr. Fitzgerald, the findings are in direct conflict with the conclusion that there is no problem. He said, "I intend to follow up this incident"—this is the part I want to get at—"that as of this writing, the DCAA was continuing to refuse repeated Air Force requests for copies of the work papers reviewed by the committee staff."

General WEISS. No, I have been told DCAA has released to the Air Force whatever documents that they asked for.

Chairman ROTH. I would like to know what date that was.

General WEISS. The administrative contracting officer at the Hughes Tuscon plant has always had access to any documents which he wished to see.

Chairman ROTH. Let me ask you, in your own experience, does DCAA always supply you with anything you request?

General WEISS. I have had very fine success in getting what I needed by working with the DCAA. The problem that DCAA has had, as we all have had in the acquisition community, is in the last 3 years, the workload has tremendously increased and the resources and skill levels of the people——

Chairman ROTH. That is the oldest alibi in town. You have 4,000 auditors there and have been authorized by Congress to hire 400 more. I just do not accept that. You have got the largest budget in history and, frankly, you tell me it takes 15 years to change a regulation on compensation——

General WEISS. Five years, sir.

Chairman ROTH. Five years, I apologize.

General WEISS. It is still too long.

Chairman ROTH. Way too long. The thing that concerns me is the lack of aggressiveness and I don't know of any requests that have come up, at least they have not been called to my attention, as to the reason for the inadequacies. The Director of DCAA, when he appeared last week, stated in his testimony that everything was hunky-dory, everything was fine. The agency was doing a good job.

General WEISS. I experience delays in our system in getting audit reports to negotiate and settle contracts, to negotiate new contract proposals. It takes, in many cases, longer than the 30 days we try to use as a standard. I am aware of some of their workload problems.

Mr. Chairman, you referenced the black boxes and the Hughes Corp. and the Tucson City Police have done the investigation of the recent occurrence. Their findings have been stated that the employees involved did not work with or work for the Hughes Corp.

They said that it was made by Hughes in order to facilitate sales. We do have an FBI investigation that we are waiting to get an answer on. It is coming near its conclusion. We expect a report shortly.

Chairman ROTH. As I understand on that, as you say, the FBI is still investigating.

Are there indications that there are similar productivity problems at other contractor plants like those at the Hughes Tucson plant?

General WEISS. We have done as a result of our review of Hughes Tucson, we have gone out to five other facilities that are listed in my testimony. We don't find anything that compares at this point with what we found at Hughes. I must hasten to add that the numbers that were quoted by Mr. Fitzgerald reflect numbers of the relationship between the standard time and what actual hours are being incurred on a program that is still in full-scale development.

While I abhor those ratios and numbers, I have got to recognize the fact that those numbers are based upon a very small limited sample of 93 guidance sections, which is the new part of the IR maverick, and 33 missiles that were being made in a development and test environment with heavy hands on engineering personnel and very high start-up costs.

We forecast and have commitments to see very significant reductions in the ratio of those costs of standard times through actual hours and the way you come up with that is you divide the standard time into the actual hour and you come up with a ratio of whatever.

We can share with your staffers at Andrews the information on what those standard times look like based upon the commitments on the part of Hughes and projections. I can't commit them to the record because they are competition sensitive, since we are trying to bring on board and will bring on board an alternate source for those programs in 1986 in a competitive environment and they will be making the hardware in 1985.

Chairman ROTH. In our earlier hearings, we found that in a number of cases, the Government negotiators were negotiating on the basis of audits that were qualified. I am sure you understand what I mean by qualify, but perhaps everyone here does not. My understanding is that when the auditors of DCAA do not have adequate access to the information that they feel is critically important for negotiations, they will qualify it.

Apparently, this has become a rather regular practice, it is not just very exceptional. Are you familiar with the problem?

General WEISS. I am not familiar that it is a regular practice.

Chairman ROTH. Are you familiar with the number——

General WEISS. No, some reports are qualified because of the time required to develop the report. I am not aware that it is a general problem, at least it hasn't been brought to my attention.

Chairman ROTH. Let me say, the IG testified last week that this was a serious problem. Do you disagree with him?

General WEISS. I have no reason, to my knowledge, at this point to agree or disagree with him.

Chairman ROTH. Is that within your area of responsibility?

General WEISS. Yes, sir, in terms of our——

Chairman ROTH. Isn't it a fact—you say they don't have time enough.

General WEISS. In my cases, it is a timeliness problem and they request——

Chairman ROTH. Let me point out Secretary Orr said he was willing to permit some stoppages, if necessary, in order to get reasonable compensation. Wouldn't it also be reasonable to refuse to negotiate with some of these contractors until they give you the information on which you can negotiate intelligently?

General WEISS. Yes, sir, we have.

Chairman ROTH. That is contrary to what the committee was told by the IG. You see that is the problem, the procurement establishment comes over here and everything is hunky-dory.

General WEISS. Sir, I need to know the specific case to validate——

Chairman ROTH. You are at the policy level and I am asking you, are you satisfied with the kind of audit that is being received by the contract negotiator? Is it satisfactory to negotiate on the basis of qualified audit?

I realize there are always some little footnotes on this, that or the other thing, but I am talking about instances where you have major qualifications, are you satisfied where you are now?

General WEISS. Sir, it depends upon the nature of the qualification and the magnitude of the dollars that are affected.

Chairman ROTH. I am asking you a question—you are at the policy level—are you satisfied with the quality of the audit reports on which the Government negotiators negotiate? Are you satisfied?

General WEISS. Yes, sir, I am satisfied on the general basis of the quality of the——

Chairman ROTH. I just want to point out the Inspector General is not satisfied, and I would urge you to review this situation and I would like to have a subsequent report on what you find.

General WEISS. I surely will. I deal with Mr. Vander Schaaf and his people regularly.

[The information follows:]

The issue of qualified audit reports has not been a point of contention between DCAA and the Air Force. In this regard, we are generally satisfied with the quality of the reports we are getting from the DCAA.

Chairman ROTH. I would like to ask a similar question as to the adequacy of the evaluation of subcontractors' pricing proposals. Are you familiar with that problem?

General WEISS. I am familiar with the issue.

Chairman ROTH. Are you satisified with the adequacy of these evalutions of subcontrator pricing proposals?

General WEISS. In the subcontract area, it has been a more difficult task to get the audit reports in and get field pricing reports in. It is hard to give any of that a yes or a no. Again, I feel that there are more improvements to be made in the area of subcontract audit and evalution.

Chairman ROTH. What measures are being taken to improve that currently?

General WEISS. Within the Air Force, we are trying to cause the prime contractors to put more emphasis into the negotiation process and their analysis of subcontractors. You have been involved in the business and you are aware it is the prime contractor's responsibility to come up with a proposed settlement in agreement with their vendors and subcontractors. Our emphasis is placed there.

Chairman ROTH. Let me ask you this question. In many cases these contracts we are talking about amount to hundreds of millions of dollars, maybe even higher, is that correct?

General WEISS. Yes, sir, they run the gamut.

Chairman ROTH. On these major contracts, do you think it is adequate to rely on the prime contractor, or do you think the Government should at least audit to ensure for itself there is adequate pricing information?

General WEISS. I believe we have a right and a responsiblity and we do audit these major programs through the use of the DCAA. We have a right and a responsiblity to look at the settlement and determine whether we feel that settlement has been done in an adequate fashion.

Chairman Roth. Just let me point out, General, that in the IG's report on subcontractors' pricing proposals released in January of this year, he stated the following:

> We found that subcontractor pricing proposals were not always properly analyzed by either prime contractors or Government audit/technical agencies. Further, in those cases where such analyses were made, the results were not always given appropriate consideration when negotiating prime contractor prices. Generally, the DOD internal audit agencies had not audited contracts included in our review and, in fact, placed very little or no emphasis on evaluating subcontract management areas. As a result, potential savings are not being adequately identified and doubts will persist as to whether the DOD negotiated a fair or reasonable price for major weapon systems acquisitions.

Are you familiar with that?

General Weiss. No. I am not, sir.

Chairman Roth. Is this not something that would come within your purview?

General Weiss. It may. It is a DOD IG audit report to cover a specific system or prime contractor?

Chairman Roth. For example, they include the pricing reviews for the F-100 engine contract. It is report No. APO 84-3 on the review of audits and other evaluations of major subcontractors' pricing proposals.

General Weiss. Sir, that is the F-100 engine.

Chairman Roth. And the Air Force was asked to comment on it.

General Weiss. We are commenting on it.

Chairman Roth. You personally have no acquaintance with it?

General Weiss. Again, is that the F-100 engine?

Chairman Roth. It is part of the interim report, yes, but it is only one part.

General Weiss. I am aware of the comments of the IG with regard to the F-100 engine and we have taken exception in providing comments to the DOD——

Chairman Roth. But you have no personal knowledge of it yourself?

General Weiss. In what way, sir?

Chairman Roth. When I read it, you were not familiar?

General Weiss. Quite honestly, we have many DOD IG reports in process at any given time.

Chairman Roth. Wouldn't you say one reviewing subcontracting is not an ordinary report but should have considerable——

General Weiss. The review of subcontractor proposals, as you said, can be large. We have a responsibility through the prime contractor to insure they are doing their job.

Chairman Roth. Let me say I understand this report was delayed a year in process before it was issued.

General Weiss. There are many ways that we use in addition to prime and DCAA support in evaluating subcontractor proposals. In many cases, we will send a team of people from the procurement contracting office of the buying division out to assist and facilitate the evaluation of those contractors' proposals.

In some cases we provide support from the Air Force plant representative. We try to use all the tools in the toolbox to make sure it works.

Chairman Roth. I would appreciate being advised in writing as to what measures are taken based upon this IG report.

General **Weiss**. Do you have a number of that IG report?

Chairman **Roth**. Yes, General, we will give you the full information.

General **Weiss**. This is the one on the F-100 engine. They did correct already many of their findings based upon data that we provided them.

Chairman **Roth**. This is the final report.

General **Weiss**. There were many that were changed before the final report.

Chairman **Roth**. I would appreciate being so advised.

[The information follows:]

While we have taken no actions specifically as a result of this DODL/IG report, we do share many of the concerns expressed in that report. For example, the should cost review which was completed prior to the Lot IX F-100 engine contract negotiation identified subcontractor cost of pricing data as a negotiation identified subcontractor cost or pricing data as a problem area. However, these problems were corrected prior to the final negotiations. Another area of shared concern has been the Pratt & Whitney purchasing system. On 3 June 83, as a result of a Contractor Purchasing System Review conducted in April 83, the Air Force disapproved the Pratt & Whitney system.

Chairman **Roth**. Let me conclude at this state that I want to go back to the question of compensation, because I think that is a critically important problem, and I am not going to be satisfied until we determine that there is adequate access to records from the principal contractors. I want to know on a contrator-by-contractor basis, and I have asked the IG to investigate whether or not they find the compensation rates reasonable. In those cases where it is not reasonable, I want to know what action is being taken.

I can't stress too much that I think it is important that we incorporate reforms to insure that our procurement is prudent. I think you are losing a lot of confidence out among the public with the current practices, because the feeling that the Government procurement people are aggressive in trying to get the biggest bang for the buck is just not there. I urge you to look into this question of compensation.

I do in a sense feel with regard to the Air Force that we are lecturing the choir a little bit because the Secretary of the Air Force, perhaps over the opposition of the procurement establishment, is trying to do something. But we are going to be here a long time and we are going to watch and see what happens in this area. I appreciate you coming today.

General **Weiss**. May I make a comment, sir?

Chairman **Roth**. Sure.

General **Weiss**. I believe the Secretary of the Air Force would say that with the support of the procurement community and how broadly you define it, he feels he is getting the support.

We, too, Mr. Chairman, are very much concerned and are working very, very hard to take on this issue of compensation. We need the regulatory changes that we have gotten in one case and there is another case coming. The litany of things we have done, we have canceled forward pricing rate agreements, we have negotiated tough, we provided data to our contracting officers on what is happening throughout the industry and in the private world, we have created a data bank in Albuquerque, N. Mex., to be able to provide intelligence on what we should negotiate.

It is a complex area, I think you would admit and it is a tough area to quantify——

Chairman **Roth**. General Weiss, it is difficult to quantify. It is a complex area and I don't expect—I know full well that one part of the Pentagon is not going to attack another directly. But, frankly, in the area of compensation, that is something you can quantify and that is what we are going to be interested in.

I think one of my concerns, you talk about the changes, is I want to see how aggressive you—I don't mean you personally——

General **Weiss**. You can point to me personally, sir.

Chairman **Roth**. To see how aggressive you are in bringing about change because I think it is a serious charge and there are many people on the outside as well as inside that believe that a much better job can be done in this area. So I will look forward to working with you.

General **Weiss**. Thank you, sir.

[The prepared statement of General Weiss, and responses to written questions from Senator Roth and Senator Percy follow:]

PREPARED STATEMENT OF BRIGADIER GENERAL BERNARD L. WEISS

MR. CHAIRMAN - MEMBERS OF THE COMMITTEE

I am honored by the opportunity to provide to you the views and actions of the Department of the Air Force on the important and highly complex issues concerning contractor employee compensation and labor distribution to include efforts to improve the productivity of defense contractors. We fully support and need the efforts of all members of the Air Force team within the Secretary's office, the Air Staff and the men and women, both civilian and military, of the Major Field Commands who work these difficult issues on a daily basis.

I am the Director of Contracting and Manufacturing Policy for the Deputy Chief of Staff for Research, Development and Acquisition on the Air Staff. As such, I am responsible for policy formation, and its dissemination. I have spent 25 years of my career in the Air Force in contracting and manufacturing. I have served in all aspects of this business from buyer to contracting officer, plant office chief to Chief of Contracting at Aeronautical Systems Division at Wright Patterson AFB, Ohio.

The Air Force contracting function is separated into three major parts: The Air Force Systems Command (AFSC) is concerned with the acquisition and contracting for the research, development, test, evaluation and production of new weapon systems, subsystems and components. Product Divisions, such as the Aeronautical Systems Division and the Space Division, carry out the Procuring Contracting Officer responsibilities from initial research through production and negotiate various contracts to acquire the equipment and services needed to support the Air Force mission. The AF Contract Management Division (AFCMD) at Albuquerque, New Mexico, is concerned with administration of AF contracts awarded to contractors under Air Force surveillance to include those also awarded by the Army, Navy, DLA and NASA. AF Plant Representatives (AFPRs) are located at each contractor facility under Air Force cognizance such as Pratt and Whitney, West Palm Beach, Florida and Boeing, Seattle, Washington.

Air Force Logistics Command is concerned with contracting for logistics to support weapons systems and hardware in the Air Force inventory. Contracting is done at the five Air Logistics Centers at Kelly AFB, Texas; Tinker AFB, Oklahoma; Hill AFB, Utah; Robins AFB, Georgia; and McClellan AFB, California. The balance of the contracting functions for the Air Force, rests with the other Major Air Commands such as the Tactical Air Command, the Strategic Air Command, and United States Air Forces in Europe (USAFE). They are responsible for local purchase support to include services, repairs and rehabilitation of facilities. In total, these activities obligated in FY83 over $41 billion on 4.8 million contractual actions.

The first topic I wish to address today is contractor employee compensation cost. I cannot overemphasize the importance of compensation costs. If you analyze a typical defense contract you will discover that, on the average, 70% of the total contract cost is employee compensation of the prime contractor, subcontractors, and suppliers. This compensation cost includes the wages of hourly employees, the salaries of management, and the incentive compensation arrangement of company executives. It also includes the fringe benefits, such as vacations, holidays, pension plans and group insurance, of all company employees. Clearly, we should be concerned about this very substantial element of cost.

Obviously, the regulations which govern our treatment of employee compensation costs are very important. I want to take a moment to explain these regulations because there is a great deal of confusion regarding what they legally allow us to do. I also want to explain why the Air Force has been, and is, pushing hard to change some of this regulatory coverage.

There are two basic regulations which cover employee compensation costs. These two regulations act as a balance to one another. The first is Section 12-101.1 of the Defense Acquisition Regulation (DAR). This section requires neutrality on the part of the government with regard to employee/employer deliberations about compensation. This means that we cannot become directly involved in labor/management negotiations or dictate what contractors can pay any of their employees. This regulation is balanced by our Cost Principle Regulations which require that we only include reasonable costs in the prices of contracts we negotiate. The cost principle that covers contractor employee compensation cost is DAR 15-205.6. This principle requires that total compensation costs be reasonable in comparison with total compensation paid by "other firms of the same size, in the same industry, or in the same geographic areas".

For many years, the Air Force has felt that the language of DAR 15-205.6 was inadequate. In our view, the test for cost reasonableness under this regulation was ineffective and did not provide an adequate basis for challenging the reasonableness of compensation costs in defense contracts. Beginning in 1978, the Air Force spearheaded and supported proposals to strengthen existing regulatory language.

These proposals resulted in Defense Acquisition Circular (DAC) #76-43 which was released in March 1983 and amended the DAR coverage on compensation costs. I will provide the Committee some charts describing the details of the differences between the original and the revised DAR language. In summary, the changes:

- Strengthened the criteria by which we determine the allowability of personnel compensation cost.

- Provided a basis for us to challenge individual elements of employee compensation even though the overall level of employee compensation is considered reasonable.

- Introduced specific language to cover unique severance pay and executive incentive compensation plans.

It is important to note, however, that there was no change in the basic language applying to the total compensation cost reasonableness test.

When DAC 76-43 was released there were two immediate reactions. First, many objections were raised by defense contractors, and others, that the new language was far too tough and restrictive. At the same time, the prevailing view within the Air Force was that the new language was still inadequate and needed further strengthening. Our primary problem with the new DAR coverage is that it still places the burden on the government for proving the contractor compensation costs are unreasonable rather than requiring contractors to demonstrate that their costs are reasonable. Additionally, we feel that the DAR language does not clearly permit us to include local labor market data in our reasonableness determinations when the contractor's compensation levels approximate those of companies of similar size and in the same type of industry. This means that a contractor's compensation levels could be significantly higher than those of the local geographical area and still meet the reasonableness criteria of the regulation.

As a result of these concerns, the Air Force introduced another proposal to amend the acquisition regulations. This proposed amendment to DAR 15-205.6 was introduced in 1983 and is in the coordination process. Our proposed language would place the burden of proof on the contractor for showing that compensation costs are reasonable, and allow us to use local labor market data in arriving at a determination of reasonableness.

As you can see, we are putting heavy emphasis on establishing proper regulatory coverage of compensation cost. Since taking over the Chairmanship of the DOD Cost Principle Subcommittee in 1981, the Air Force has assumed the leadership role in developing and implementing the needed coverage. We feel that this coverage is essential if we are to pursue aggressive cost control. We know that our aggressive actions will be challenged. However, without the needed regulatory changes our efforts may not be sustained by the Armed Services Board of Contract Appeals and the courts.

Now that I have discussed our compensation regulations, I want to describe the factors which we must consider when we analyze the reasonableness of the employee wage and salary portion of compensation cost which we call "labor rates". Let me emphasize that we negotiate agreements that consider labor rates which cover the services of both hourly wage earners and salaried professionals. In doing this we must look at many factors such as historical contractor practices, workforce changes resulting from contractor business base changes, local labor market conditions, national salary trends, and trends in union settlements. Additionally, analysis of this type is highly dependent on economic forecasting in order to predict inflationary trends. As you can see, some very complex analysis is involved which cannot be characterized as mere statistical extrapolation. Finally, I think it is important that you understand that our analysis and negotiations of employee compensation costs do not involve just salaries and wages for direct employees. We must also review indirect salaries, wages, and fringe benefits, which constitute the largest element of overhead costs.

Secretary Orr's approach to compensation costs has been more aggressive than prior Secretaries of the Air Force. While we carefully avoid any change to our position of neutrality, the Air Force did come on line in April 1982 through Mr. Orr's leadership, clearly telling industry that while we will not inject the Air Force into the employee/employer compensation process, we would only recognize those prices for hardware and services which reflect reasonable increases.

Although AFCMD routinely looks at compensation levels in their Contractor Management System Evaluation Program reviews, this subject has received special high-level attention dating back to 1981.

° In August 1981, AFSC performed a study comparing the compensation levels of defense contractors and commercial firms. We found that compensation levels were approximately equal for firms of the same size regardless of whether they were commercial or defense contractors.

° In 1981, the AFSC Commander launched the Affordability Acquisition Approach (A3) project. This study, which looked at ways to improve cost management for the whole acquisition process, recommended a series of actions to overcome problems caused by funding instability, cost growth, and schedule stretch-out. The Air Force is applying these recommendations to all major programs.

° In 1982, we initiated a project to review government requirements which contribute to contractors' overhead costs and encouraged them to evaluate the effectiveness and necessity of their current indirect activities. As a result, the buying divisions are using business review teams and murder boards to make sure that we are not requiring contractors to provide us with costly excessive requirements.

° On 7 September 1982, our Assistant Chief of Staff directed us to identify and implement ways to expand the basis for projection of compensation costs. Commanders were directed to aggressively challenge excessive compensation, at all levels, in contract negotiations.

° The AFSC Commander, in October 1982, began positive cost containment action by establishing his Project Cost Program. Efforts for this program have been focused in three areas: (1) weapon system affordability, (2) program stability, and (3) program management. A large portion of the Project Cost effort has been dedicated to finding ways to reduce both contract hours and compensation costs.

° Under Project Cost, AFSC has:

-- Studied contractor labor negotiation procedures and found that contractors follow acceptable procedures in that aerospace contractors plan their negotiation strategies and aggressively pursue the best possible settlement to reduce overall cost and increase productivity.

-- Strengthened its efforts to obtain better cost leverage through the use of Forward Pricing Rate Agreements.

-- Used Defense Contract Administration Service employee compensation system reviews more extensively. Since Project Cost began, we have conducted 23 formal compensation system reviews and for the next two years, we have asked the Defense Logistics Agency to perform an additional 43 compensation reviews across the country.

-- Hired a compensation specialist at AFCMD and has issued a technical services contract to develop an independent data base for compensation and fringe benefit costs which facilitates critical evaluation and timely determination.

-- Developed regulatory changes relating to compensation issues as discussed previously regarding the reasonableness criteria, tying incentive compensation to individual employee performance.

During the first year of Project Cost, AFSC concentrated its compensation control efforts in the areas of forward pricing and economic price adjustment caused by abnormal inflation.

° The Commanders of AFSC and AFCMD have written at least four policy letters to Air Force field activities stating that forward pricing is one of our best tools to influence future contractor cost containment.

° Escalation rates have received comparable attention:

- On 29 Sep 82, the AFCMD Commander and the AFSC Contracting and Manufacturing Deputy Chief of Staff jointly instructed their field offices to make sure that direct labor rates and annual increases were reasonable and equitable.

° The Vice Commander of AFSC on 14 Oct 82 reemphasized this point by stating that our objective is to negotiate rates which reflect a realistic estimate of future costs.

° The AFSC Contracting and Manufacturing Deputy Chief of Staff on 10 Dec 82 again instructed field contracting officers to improve their practices for pricing inflation.

° The AFCMD Commander shortly thereafter (28 Feb 83) stated that labor rate escalations in excess of inflation must be justified with respect to productivity and that proposals must reflect labor hour reductions.

° In April 1983, the AFCMD Commander began issuing inflation guidance directly to his field activities.

° Beginning in May 1983, the Air Force Directorate of Contracting and Manufacturing Headquarters published quarterly collective bargaining trends. This report is used by our Contracting Officers when they prepare their contract pricing strategies.

Secretary Orr and the AFSC Commander both have personally discussed the Air Force compensation concerns with top aerospace executives.

° Secretary Orr hosted a meeting with 11 aerospace executives at Fort McNair on September 21, 1982, and discussed compensation costs. These industry leaders pledged their support to make attempts to control compensation cost.

° The AFSC Commander, on 16 Feb 83, sent letters to 29 aerospace Chief Executive Officers asking them to consider curtailing further increases in salaries, bonuses, and fringe benefits for direct and non-direct salaried personnel involved in aerospace defense contracts for the current or next corporate fiscal year.

° On 15 July 83 at the AFSC/Chief Executive Officers Conference, the AFSC Commander discussed AFSC forward pricing actions, wage and salary escalation trends, and health care costs with 29 top aerospace executives. The industry leaders again pledged their support.

No one Service works in a vacuum since the contracting policies and procedures of one organization can affect the activities of another. Therefore, on 30 March 83, the AFSC Commander discussed the compensation issues with the Commanders from AFLC, DARCOM, and NAVMAT. These Joint Logistics Commanders concluded that there was a need for joint service action to control compensation costs. They established a group called the Joint Compensation Advisory Group with representatives from all the Services, DLA, and DCAA. The group is chaired by AFSC.

° On 13 December 83, the Joint Logistics Commanders endorsed 11 initiatives to:

-- Improve information exchange among the Services and Agencies on compensation matters;

-- Enhance the communications flow between buying and contract administration activities;

-- Provide field personnel better cost analysis guidance;

-- Seek ways to uniformly estimate inflationary compensation cost increases.

° Secretary Weinberger received the Commanders' report which explored ways the Department can control the growth of labor and overhead costs. The Air Force has been concerned about compensation costs and it has received considerable high-level attention. The tangible outcome of these policy actions are:

° First, the level of awareness for compensation cost control has been heightened to our field buying and contract administration personnel.

° Second, at most of our locations we have held forward pricing rates in line with economic trends and productivity factors.

° Last, we will provide our contracting officers with even better information to effectively price the compensation portions of our contracts. We are working with OSD to update several pricing manuals and intend to provide contracting officers with sufficient information so our contracts adequately reflect economic trends.

With regard to the issue of labor distribution, the Air Force has been actively pursuing this area for the past decade. We have recognized that a system of "should take" time standards provides a foundation for improving labor efficiency. By comparing the time a task actually takes against the time that it "should take", the efficiency of hands-on labor can be calculated. This process highlights areas of poor performance so that corrective action can be taken.

To ensure this concept was employed by our defense contractors, the Air Force developed and published a Military Standard on Work Measurement in June of 1975. Military Standard 1567(AF) was applicable to Air Force acquisitions, other than firm fixed price, of $20M annually or $100M cumulatively.

The Air Force pressed forward to include the Military Standard on appropriate contracts. The following policy and guidance actions were taken to emphasize implementation:

- In April 1976, Air Force Systems Command issued a policy letter advocating implementation of the standard and designating the Air Force Contract Management Division as the lead agency for promoting implementation.

- By early 1978, six systems had the standard on contract.

- In March 1978, a second Air Force Systems Command policy letter was issued with stronger direction for implementation.

- By mid 1978, thirteen systems had the standard on contract.

- In May 1979, Air Force Systems Command published a regulation AFSCR 84-7 "Work Measurement" to ensure uniform implementation.

- In June 1980, the Comptroller General issued a report to Congress recommending the concept be applied to all defense contracts under the Army, Navy, and Air Force.

- On 11 March 1983, a DoD version of the Military Standard was issued. Air Force Systems Command led the development effort under the auspices of the Joint Logistics Commanders. The new Military Standard enhances the use of work measurement as a cost reduction and productivity improvement tool by making it applicable to firm fixed price contracts. It also tightens the accuracy requirements and requires labor standards to be used as a basis for estimating contract changes, initial and replenishment spares, and follow-on production buys.

In addition to publishing the DoD Military Standard in 1983, the Air Force has strengthened other key areas of policy and guidance:

- In Feb 83, Air Force Systems Command directed the use of standard hours to price certain contracts. AFSC also updated the requirements for using the standard in its regulation on Manufacturing Management, AFSCR 800-9.

- In March 1983, I directed AFSC and AFLC to employ the DoD version of the Military Standard.

- In Nov 1983, I published Air Force Regulation 800-9, "Manufacturing Management Policy for Air Force Contracts" which further defined and emphasized the application of this Military Standard.

In parallel with the tightening of policy, efforts have been made to provide application guidance to the field. An application guide for the new Mil-Std is in the process of development. It is presently being reviewed in the Air Force Secretariat. In the interim, AFCMD published application guidance on 23 Jan 84 for use by its Air Force Plant Representative Offices.

This past October, AFCMD conducted a study of the contracts under its cognizance to review the application of the Military Standard. At that time, 53 of the 132 Air Force contracts which met the criteria had the standard applied.

While progress has been made, there is much remaining to be done. As efforts over the past years indicate, management attention has been focused on capitalizing on the opportunities provided through Military Standard-1567. The policy and guidance has been clarified and we are working hard to effect implementation to achieve the results of improved contractor efficiency which results in reduced weapon systems cost.

In addition to the development of policy and guidance, we have been actively evaluating contractor's work measurement systems. In 1974, the AFCMD formalized this effort in the Contractor Management Systems Evaluation Program (CMSEP). One part of that comprehensive program focused on the existence, adequacy, and implementation of the contractor's work measurement system and was conducted whether or not Military Standard 1567 was on contract. On those programs where Military Standard 1567 is on contract, we have ensured contractual requirements have been met.

The CMSEP and contractual compliance reviews are continuing efforts. In order to gain further visibility into contractors' productivity we have been conducting specialized reviews. In Sep 1982, General Skantze, then Deputy Chief of Staff, Research Development and Acquisition, HQ USAF, directed a review of the Hughes Tucson facility to determine if it would have the capacity to make the many tactical missile systems that Hughes produces for the Army, Navy, and Air Force. This study was conducted by the Air Force Contract Management Division with representatives from the Army and Navy. The study concluded that insufficient capacity existed for future requirements due to poor productivity and quality at the plant. Realization factors (actual hours expended divided by standard hours) ranged from 17.6 for the IIR Maverick Full Scale Development Program (93 guidance sections/33 missiles) to 1.6 for the TOW missile (300,000 missiles produced).

While we are very concerned about high realization factors, we have been careful to ensure they are used in the proper context. For example, the 17.6 factor just stated is based on development effort which includes nonrecurring work conducted on the Maverick program such as rework to correct flaws identified during testing. Standards should not be reached on Maverick or any other program until stable, rate production is reached. Before using any data, we make sure that we understand what is included in the standard hour baseline; what allowables are included in the standards and how the contractor's cost accounting system works.

Specific comparisons between different or similar products produced by several contractors require this same careful analysis to ensure we are comparing like situations. The difference in the content of a standard hour, the complexity of the product, the program maturity and rate of production are a few of the variables which must be considered. In certain cases, when data of this nature is available, a rough comparison can be made, if allowances for differences are used. When allowances are not made, however, comparisons are misleading.

More specifically, our analysis of the Hughes' realization factors indicated their performance was unacceptable. Undisciplined work habits and lax management were among the factors contributing to this situation. The results of the review were briefed to Secretary Orr in Feb 83 and Deputy Secretary of Defense Thayer in March. A followup review to determine progress was conducted in June of 1983. This review revealed that little progress had been made to improve productivity on the manufacturing floor. Secretary Orr met with Hughes corporate management in late August 1983 to express his concern over their performance and, as a result Hughes agreed to provide a plan to improve productivity at their Tucson facility. The plan is being implemented at present and the AFPRO at Hughes is monitoring progress. Our latest negotiations with Hughes on the IIR Maverick took into account Hughes' commitment to improve productivity and we negotiated a reduced price.

Recognizing the utility of such studies, Secretary Orr directed the Air Force to conduct five more "Productivity Reviews" of major defense contractors. The contractors reviewed were:

Boeing Aerospace, Seattle, Washington	May 83
Lockheed, Marietta, Georgia	Jul 83
Raytheon, Lowell, Massachusetts	Sep 83
Pratt and Whitney, East Hartford, CT	Dec 83
General Dynamics-Convair, San Diego, CA	Feb 84

The results of these reviews are in the process of being summarized and are currently scheduled to be briefed to Secretary Orr this spring.

We also have been working to strengthen our contract estimating efforts through greater emphasis on the Air Force Should Cost Program. In June 1982, the Armament Division (AFSC) at Eglin AFB, Florida, conducted a Should Cost for the GAU-8 Gun Pod at General Electric, Burlington, VT. This review used work measurement techniques to arrive at its conclusions and recommendations instead of using historical costs. A price reduction of approximately 27% was obtained. As previously mentioned, the IIR Maverick Program Office used work measurement techniques to estimate and support negotiations of the contract price. A price reduction of approximately 16.4% was negotiated. Most recently, formal Should Costs were conducted on the last annual F100 engine buy and on the GBU-15 (Modular Glide Bomb) and both have netted significant results.

Our reemphasis on the use of Should Cost is being institutionalized in an Air Force Supplement to the Federal Aquisition Regulations and in an update of Air Force Pamphlet 70-5 "Should Cost", which will emphasize the use of work measurement to evaluate direct manufacturing labor and will address other techniques to evaluate the indirect costs which have become a large percentage of contract prices.

We are in the process of developing new Air Force policy and procedures to control indirect costs. The advances in computer technology and integrated software approaches enable indirect as well as direct costs to be accurately and expeditiously identified. The Air Force Integrated Computer-Aided

Manufacturing Program contributed significantly to these advances. We are currently evaluating an approach proposed by an industrial consulting firm which includes demonstrating their system at a defense contractor.

In addition to focusing on the proper and efficient use of direct and indirect labor categories, we also have been working to ensure state-of-the-art manufacturing processes and capital equipment are available for the production of weapons systems and hardware.

Our Manufacturing Technology program has been in operation for 37 years. Its objective is to encourage industry to develop state-of-the-art manufacturing processes in those areas of weapon systems manufacturing where there is little commercial application and insufficient incentive to develop the technology in the private sector. We are currently focusing our efforts on ten areas. They are:

1. Airframe Production and Productivity
2. Low Observables Materials Manufacturing
3. Propulsion Systems Production
4. Electronics Integration and Assembly
5. AFLC Maintenance and Repair Productivity
6. Computer Integrated Manufacturing
7. Strategic Missile Production
8. Space Systems Production
9. Tactical Systems Production
10. Manufacturing Science

We have budgeted $57M in 1984 to carry on this program. By enhancing manufacturing efficiency it has resulted in substantial cost reductions throughout the years. A recent study of eight contractors documented the savings to the Air Force to be $450M for an investment of $33M.

The other technology related program we have been aggressively pursuing is that of incentivizing our defense contractors to modernize their factories to improve the productivity of the defense industrial base. We have developed techniques which permit the contractor to share in the savings that would be realized through the introduction of the latest capital equipment, improved manufacturing processes, and other factory efficiency enhancements.

The program is called the Industrial Modernization Incentives Program and is presently operating under a Department of Defense sponsored test. Its predecessor was the Air Force Technology Modernization Program which began with an arrangement with General Dynamics-Fort Worth in 1976.

The arrangement between the Electronics Systems Division (AFSC) at Hanscom AFB, MA and Westinghouse Defense and Electronics Systems Center, Baltimore, MD provides a good example of how the program works. A government investment of $8.9M and a contractor investment of $55M resulted in the development of a modern electronics assembly plant and electronics assembly and material handling technologies that capitalized on advances in computer software and robotics. These investments are estimated to reduce the price of government contracts by approximately $350M through 1992.

Today, we have arrangements with 26 prime contractors and over 30 subcontractors. The Air Force has invested $276M; contractors have invested $955M and we project cost avoidances to the government as a result of these arrangements to be in the neighborhood of $2.5B.

In conclusion, Air Force actions to control and reduce unrealistic costs have been many. Considerable emphasis to gain authority and needed leverage on compensation costs stem from 1978 when we began to strengthen the role of the contracting officer through regulatory change. More recent actions concentrated on specific aspects of wages, salaries, and fringe benefits through compensation system reviews and tough negotiating on Forward-Pricing Rate Agreements.

In the area of labor distribution and productivity enhancements, our efforts in the 1970's to develop industrial engineering work measurement techniques are starting to pay off in contract negotiations and industry actions to control and reduce costs. Should Cost techniques and Manufacturing Management/Production Capability Reviews (MM/PCRs) are identifying inefficiencies in contractor practices that must be corrected. Our identification of the "Hidden Factory", such as the costs of scrap and rework are focusing attention on improvements needed in the area of quality assurance. Indirect costs are getting stringent reviews by both our Air Force Plant Representatives and Program Offices. Through our Manufacturing Technology and Industrial Modernization Incentive Programs, we are making progress in causing American industry to modernize their facilities and equipment by bringing the factory of the future into the 1980's. These are some key examples where we are working to drive up efficiency and productivity on our programs where we negotiate with a single source and the competitive market pressures are not present.

Increased use of competition, dual sourcing and leader-follower procurement do create market forces to cause greater productivity and cost reduction. Efforts under the recent Alternate Fighter Engine program, follow prior successes with the GAU 8 Ammunition Program, the ACES II Ejection Seat and efforts under the "Form, Fit and Function" (F3) Inertial Navigation Systems program. We have laid the foundation to continue competition, well into production, through leader-follower techniques on the IIR Maverick and Advanced Medium Range Air-to-Air Missile (AMRAAM) programs.

The causes of poor efficiency and productivity cannot be laid to rest solely in the hands of the defense industry. We in the military services, and others in government, have caused: (1) programs to be stretched out, (2) hardware to be acquired at less than efficient production rates, (3) program instability and (4) until recently, inappropriate depreciation policies and tax laws which are necessary to keep American Industry efficient for private sector and defense programs and competitive in the world market place.

The areas of compensation and productivity are some of the most complex issues that we must face. I believe we have made major progress to control costs and as the AFSC Commander has said: "We must now strive for cost reduction." He has tasked AFSC components to develop definitive plans to quantify and achieve annual cost reductions by weapon system. The AFSC Commander has categorized 1984 and subsequent years as "The Years of Efficiency". Our objective is clear. Reduce costs and spend taxpayers' hard earned dollars in an efficient and effective manner as we re-arm America.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR ROTH

Question. 1. In your testimony you stated that the Air Force is in the process of submitting proposed language to the Defense Acquisition Regulation (DAR) Council for a change in the DAR granting contracting officers the authority to gain access to, and examine, the labor compensation records of the Defense industry. I would appreciate receiving a copy of the proposed language, as well as information concerning the status and proposed timetable for its incorporation in the DAR. Why has it taken so long to make changes in the DAR to improve the Defense Department's ability to negotiate reasonable forward pricing agreements on compensation rates?

Answer. Our proposed change to the employee compensation cost principle is currently being considered by the Defense Acquisition Regulation (DAR) Council. The primary purpose of our proposed change is to tighten the criteria used in determining the reasonableness of compensation costs and shift the burden of proving reasonableness from the Government to the contractors. As the attached documentation shows, we are not seeking changes with regards to access to compensation records. We feel that current regulatory coverage allows us access to any needed compensation records.

The time table for approval of our change is controlled by the DAR Council. Because of the importance of the issues involved, our proposal will be thoroughly reviewed within DOD and then released to the public and industry for comment. This lengthy review process and the heavy workload of the DAR Council mitigate against rapid approval. However, we do expect the case to be approved before the end of calendar year 1984.

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON, D.C.
20330

6 MAR 1984

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

SUBJECT: Request for Consideration of Revision to DAR 15-205.6 (FAR 31.205-6), Compensation for Personal Services, DAR Case 83-62

I. PROBLEM:

Coverage in DAR 15-205.6 is inadequate with respect to the criteria for reasonableness and the allowability of bonus, incentive payments, and employee termination payments.

II. RECOMMENDATION:

A. DAR 15-205.6(a)(4), (b) and (b)(2) be revised to provide that (i) increased costs attendant to national changes to existing compensation plans or the introduction of new plans are unallowable unless submitted to the Government for review either prior to or within a reasonable period after implementation; (ii) the reasonableness criteria are conjunctive rather than alternative in nature, with the Government having the option of weighing and determining the relevance of individual criteria; and (iii) there is no presumption of reasonableness and, upon challenge by the Government, the contractor will have the burden of proving that the compensation at issue is reasonable in amount.

B. DAR 15-205.6(f) and (k) be revised to stipulate that the cost of bonuses and incentive compensation paid to management employees is allowable provided that the award is predicated on the degree to which the recipient satisfied pre-established performance goals.

C. That DAR 15-205.6(g) be revised to make excessive severance payments (golden parachutes) unallowable.

III. DISCUSSION:

The Deputy Secretary of Defense requested the establishment of a DAR case to review the present coverage of DAR 15-205.6 and to consider whether or not the current language should be clarified. The Department of the Air Force believes that revisions to the cost principle are warranted. Detailed discussion of the need for the proposed changes is documented in the attachment.

JACK L. McCHESNEY, Col, USAF
Air Force Policy Member
DAR Council

1 Atch
Proposed Changes
to DAR 15-205.6

MEMORANDUM FOR THE DIRECTOR, DAR COUNCIL

SUBJECT: Revision of DAR 15-205.6, Compensation for Personal Services

I. Problem:

The problems relate to the reasonableness criteria of compensation, the lack of control for bonuses and incentive compensation, and the allowability of employee termination plan payments. Each of these related subjects will be addressed separately.

In addressing the reasonableness of compensation, DAR 15-205.6(b) currently states that compensation is reasonable to the extent that the total amount paid or accrued conforms generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area, for similar services. Given this DAR language, the contractor's incurred compensation expenses are presumed to be reasonable and the government has the burden of proving that these costs do not "conform generally" with those expended by other firms of the same size, etc. Consequently, the successful disallowance of compensation costs on the basis of reasonableness requires a pristine data base which clearly demonstrates that the compensation in question far exceeds what is being paid by "comparable" firms. Concurrently, it must also be demonstrated that the services rendered and the scope of responsibility of the individual(s) involved are close, if not identical, to that contained in the comparative data base. Past experience dictates that we rarely have access to the type of discrete data required to overcome the presumption that a contractor's incurred compensation costs are reasonable in amount. Additional backround is provided in Tab 1.

With respect to incentive compensation, DAR 15-206.6(f) and (k) permit the reimbursement of bonuses and incentive compensation for management employees so long as (1) the overall compensation to these individuals is reasonable in amount, and (2) it is paid pursuant to an agreement or established plan. These DAR sections do not require that such awards be predicated on an assessment of the recipient's job performance. As a result, the government can be placed in the position of reimbursing the cost of some awards which are either based on ambiguous, subjective criteria, or measures which are totally unrelated to the recipient's individual productivity. In such cases the inducement value of the award is either totally lost or substantially diminished. It is inappropriate for the government to reimburse the cost of additional executive compensation which is not directly related to the quantity and quality of the services rendered by the managerial employee. Additional backround is provided in Tab 2.

Employee termination plan payments that appear excessive are becoming more prevalent. Recently, in order to avoid or hinder merger or takeover attempts, some companies with the approval of the Board of Directors, and in some cases stockholders, are providing key executives with excessive severance pay benefits. These payments have been referred to in newspaper articles as "golden parachutes". The language of DAR 15-205.6(g) needs to be reversed to specifically address these excessive payments. Additional background is provided in Tab 3.

II. Recommendation:

a) DAR 15-205.6(a)(4), (b) and (b)(2) be revised to provide that (i) increased costs attendant to material changes to existing compensation plans or the introduction of new plans are unallowable unless submitted to the government for review either prior to or within a reasonable period after implementation; (ii) the reasonableness criteria are conjunctive rather than alternative in nature with the government having the option of weighing and determining the relevance of individual criteria; and (iii) there is no presumption of reasonableness and, upon challenge by the government, the contractor will have the burden of proving that the compensation at issue is reasonable in amount.

b) DAR 15-205.6(f) and (k) be revised to stipulate that the cost of bonuses and incentive compensation paid to management employees is allowable provided that the award is predicated on the degree to which the recipient satisfied pre-established performance goals.

c) That DAR 15-205.6(g) be revised to make excessive severence payments (golden parachutes) unallowable.

The proposed DAR changes are included under Tabs 1, 2, and 3.

III. Discussion:

Detailed discussion of the proposed changes are under Tabs 1 thru 3. These changes provide additional guidance and coverage to the compensation area.

MEMORANDUM TO THE DIRECTOR, DAR COUNCIL

I. Problem

DAR 15-205.6(b) currently states that compensation is reasonable to the extent that the total amount paid or accrued conforms generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area, for similar services. Given this DAR language, the contractor's incurred compensation expenses are presumed to be reasonable and the government has the burden of proving that these costs do not "conform generally" with those expended by other firms of the same size, etc. Consequently, the successful disallowance of compensation costs on the basis of reasonableness requires a pristine data base which clearly demonstrates that the compensation in question far exceeds what is being paid by "comparable" firms. Concurrently, it must be demonstrated that the services rendered and the scope of responsibility of the individual(s) involved are close, if not identical, to that contained in the comparative data base. Past experience dictates that we rarely have access to the type of discrete data required to overcome the presumption that a contractor's incurred compensation costs are reasonable in amount.

II. Recommendation

Recommend that DAR 15-205.6(a)(4), (b) and (b)(2) be revised to provide that (i) increased costs attendant to material changes to existing compensation plans or the introduction of new plans are unallowable unless submitted to the government for review either prior to or within a reasonable period after implementation; (ii) the reasonableness criteria are conjunctive rather than alternative in nature with the government having the option of weighing and determining the relevance of individual criteria; and (iii) there is no presumption of reasonableness and, upon challenge by the government, the contractor will have the burden of proving that the compensation in issue is reasonable in amount.

III. Discussion

Labor and labor related costs associated with the performance of government contracts is extremely significant. An analysis of five (5) years of historical data covering contractors under AFCMD administrative cognizance indicates that these expenses constitute approximately 70% of the total cost incurred by these contractors. Naturally, the amount of labor and labor related costs associated with the performance of individual contracts varies substantially. However, on the whole, defense effort is labor intensive. Over the past several years, DOD has experienced an excessive growth in the cost of its weapon systems. To illustrate, a 1982 AFCMD survey of contractor labor negotiation practices demonstrated that the typical wage enhancements contained in aerospace collective bargaining agreements resulted in wage escalations far in excess of actual inflation. These agreements not only define the wages paid to the unionized workforce, but also impact the wages and fringe benefits paid to non-union hourly and salaried personnel. The bottom line is simple. DOD cannot afford cost growth which is unjustified in terms of productivity gains and/or inflationary trends. And yet, the existing DAR criteria does not provide a viable basis for challenging the reasonableness of excessive compensation costs. In the subsequent paragraphs, we have attempted to further define this problem and propose an appropriate solution.

A. Backround

(1) Reasonableness is one of the basic factors affecting the allowability of costs (DAR 15-201.2). Prior to Revision No. 50, 2 November 1959, DAR (then ASPR) merely cited "reasonableness" as a test germane to determining cost allowability and failed to define what did and what did not constitute a reasonable expense (ASPR 15-201(a)). Revision No. 50 introduced DAR 15-201.3 which defines "reasonableness" as follows:

> "Definition of Reasonableness. A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of competitive business..."

This DAR section remained unchanged until DPC No. 50, 30 Decmeber 1966, added DAR 15-201.3(b) and addressed the application of the CWAS (Contractor Weighted Average Share) concept. According to this concept, if a specified percentage (currently 75%) of the contractor's business was commercial and/or fixed-priced competitive government in nature, the reasonableness of incurred cost will be assumed. Per Revision No. 8, 30 September 1970, this section was expanded to explicitly address the application of CWAS to the cost principles in DAR 15-205. Specific reference is made to DAR 15-205.6 where a CWAS rating prohibits the government from challenging the reasonableness of compensation expenses regardless of whether or not these costs satisfy the reasonableness standards set forth in that particular cost principle.

(2) As is evident, DOD has traditionally applied the "prudent businessman" concept in determining the reasonableness of cost expenditures. The underlying premise has been that decisions made by businessmen operating in a commercial environment were by necessity, appropriate in light of the inherent market

constraints. Therefore, if expenditures by a government contractor were in consonance with what a prudent, commercial businessman would incur, this level of cost incurrence has been acceptable for government purposes.

(3) As with DAR 15-201.3, DAR 15-205.6, Compensation for Personal Services, was introduced by Revision No. 50. This comprehensive cost principle addresses all forms of compensations and delineates various allowability rules in connection with each type of payment. With regard to reasonableness, this cost principle further defines the basic standard set forth in DAR 15-201.3. The pertinent language in DAR 15-205.6(b) is cited below.

> "Compensation for personal services will be considered reasonable if the total compensation conforms generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area for similar services or work performed..."

This section goes on to state that the existence of certain conditions (e.g., closely held corporations, changes in compensation policy, non-competitive business base) may warrant the exercising of special consideration and scrutiny.

(4) Recently, as a result of DAR Cases 78-42 and 79-94, substantive revisions were made to DAR 15-205.6.

However, the revisions to 15-205.6 do not resolve the problem that the government has traditionally encountered in attempting to challenge the reasonableness of contractor compensation costs.

B. Problem

(1) When critically evaluated, it becomes evident that this problem is two-fold. First, the reasonableness criteria in DAR 15-205.6(b) is, for all practical purposes, unenforceable. This untenable situation is precipitated in part by the fact that the Armed Services Board of Contract Appeals (ASBCA) and relevant courts have consistently held that incurred expenses are presumed to be reasonable and the government has the burden of proving that such costs are unreasonable. The leading case in this area is Bruce Construction Co. vs United States, 163 Ct. Cl. 97, 324 F. 2d 516 (1963). In ruling on the government's disallowance of the additional cost of utilizing "sand blocks" instead of "concrete blocks" in building dormitories, the court stated the following:

> "Since the presumption is that a contractor's claimed cost is reasonable, the government must carry the very heavy burden of showing that

> the claimed cost was of such a nature that it should not have been expended, or that the contractors' (sic) costs were more than were justified in the particular circumstance." (324 F 2d 516, 519)

Granted, the Bruce Construction case addressed a pre-1959 contract that was not subject to the current cost principles. Nevertheless, the fact this decision is still good law is shown conclusively by its having been cited and followed in approximately sixty (60) cases decided in just the last (7) years.

(2) The fact that the government is confronted with a "very heavy burden" stems from the ASBCA's and courts' tendency to consider the specific circumstances involved and their extreme reluctance to substitute the judgment of the government for that of the contractor. Substantiating this point is the decision in Telecomputing Services (68-1 BCA 7023) wherein the Board noted:

> "...The test of 'reasonableness' of a given cost must be addressed, primarily, to the discretion and sound judgment of the contractor. ...If the cost does not violate the terms of the contract, and passes the tests of ASPR, the contracting officer should determine that the cost is allowable and approve it for reimbursement even if in his own judgment he would not have incurred such a cost for reasons that appear plausible to him. ...Accordingly, we shall examine the circumstances of this case from the point of view of appellant, not as a matter of hindsight on the part of the respondent..." (pp 32, 466)

Likewise, in The Nager Electric Company case (194 Ct. Cl. 835 (1971)), the court indicated that the reasonable cost concept includes both objective and subjective elements. The objective element focuses on the costs that would have been incurred by a prudent businessman placed in a similar competitive situation. However, unless it also takes into account the subjective situation of the contractor, the test is incomplete (pp 851). As a general rule, so long as a contractor can present a plausible rationale for his actions, it is extremely difficult to successfully sustain a disallowance. A blatant example of this "bottom line" is The Stanwick Corp (76-2 BCA 12,114) where the ASBCA allowed compensation paid to admittedly "nonproductive" engineers on the basis that the contractor had to retain its technical expertise in order to attract new work.

(3) Further aggravating this situation is the broad, liberal reasonableness criteria itself. A contactor's compensation only has to "conform generally" to that paid by similarly

ated firms in either the same industry, or firms in the local geographic area. Not only does the contractor have a choice of comparative statistics to choose from, it is difficult to establish when a contractor's compensation fails to "conform generally" to that paid by other relevant firms. In Lulejian and Associates, Inc., (76-1 BCA 11,880), the ASBCA noted that there is no justification for accepting salary levels only up to a mid-point in a range of comparable firms. A range below and above the mid-point must also be considered. Therefore, even if it can be established that a contractor's compensation is the highest among comparable firms, it must also be clearly demonstrated that the compensation in question is substantially above that paid by these other firms before a disallowance can be sustained. An industry or local leader which is only slightly above all comparable firms is probably not outside the "reasonable" range.

(4) Obviously, in light of the broad reasonableness criteria discussed above, a disallowance of compensation costs on the basis of reasonableness requires the existence and access to a pristine data base. By pristine data base, we are referring to data which provides precise comparisons with regard to time frame, size and type of firms, and the nature of duties, responsibilities and authority of the individuals involved. Unfortunately, this comparative data, in statistically significant quantities, is not readily available in most instances. In the Lulejian case, the government attempted to utilize information published in surveys conducted by the Chamber of Commerce and American Management Association. However, due to the general nature of the statistics provided in these surveys, the government encountered problems in connection with the disallowance of compensation paid to specific individuals since it was not possible to demonstrate a discrete comparison of individual responsibilities, etc. The necessary data may be available in private, intra-industry surveys. But again, this information is proprietary in nature and the participants rarely if ever are willing to give the government access to this data.

(5) In recognition of these problems, DLA has attempted to establish a data base predicated on the information gathered during its compensation reviews. While this data base provides a general baseline for evaluating the relative overall comparative standing of various firms, its effectiveness in a formal dispute posture is questionable. To wit, DLA has grouped its compensation data by position title. Since the scope of responsibility for a given position title differs among companies, the DLA salary range for an Assistant Project Engineer is the same as the range for Project Engineer. Concurrently, DLA's salary range for an Assistant Project Engineer is more than the salary range for a Senior Assistant Project Engineer. In our opinion, these common sense inconsistencies do not stem from an internal problem within DLA. Instead, these inconsistencies are precipitated by the magnitude and difficulty of the data collection task involved. Simply stated, the government's ability to commit the necessary resources and gain access to sufficiently discrete data is extremely limited.

(6) It has been suggested that adequate data may be available through the Bureau of Labor Statistics (BLS). Consequently, AFCMD closely examined the types of statistics routinely gathered and published by this organization. While BLS publishes discrete, national statistics by industry, comparable local compensation data is no longer available because of budget costs recently sustained by BLS. The available national information does little to substantiate the "unreasonableness" of a contractor's compensation where the contractor operates in either a demonstrably low or high cost area. To reiterate, the data required to carry the burden of proof imposed on the government is extremely difficult to obtain.

(7) Turning to the second aspect of the problem of excessive cost growth, it is debatable whether or not reliance on the "prudent businessman" concept is appropriate given our past economic experience. Assuming for the sake of discussion that the DAR 15-205.6(b) reasonableness criteria is sufficiently definite and enforceable, we submit that merely limiting allowable compensation costs to that paid by other firms in the same industry or geographical area may not be adequate to prevent cost growth which exceeds what the government can afford. As is evidenced by the recent experience in the auto and steel industries, market restraints do not always assure that firms will be "prudent" and cost conscious. Some businessmen are only "prudent" in terms of cost control when such is mandated by economic circumstances relevant to their particular sector of the market place. If effective cost discipline is not required due to the existence of a relatively inelastic demand, firms will frequently adopt a short term approach, elevating their corporate standard of living and giving little or no thought to the potential long term consequences.

(8) This lack of consistent cost discipline is particularly prevalent in the defense sector given DOD's predominantly negotiated and cost-based approach to the acquisition of major weapon systems. Once a contractor is selected to perform a major program, it becomes a "sole source" and follow-on procurements are predicated on cost and pricing data supported by its historical experience. Since, as a practical matter, profit is established as a percentage of cost, the more cost a contractor can support, the more absolute profit dollars it can receive. Consequently, many defense contractors are insufficiently motivated to practice effective cost containment. As a result, comparing a contractor's compensation costs with that paid by other firms in the defense industry can be self-serving to the extent that the whole industry compensates employees at an excessive rate. The fact that a comparison with unrelated organizations in the same area is permitted is of little solace since (i) there is no guarantee that these firms are subject to more stringent cost restraints, and (ii) DAR currently allows contractors to rebut government allegations on either an industry or local geographical basis.

(9) This is not to say that the "prudent businessman" test in DAR 15-201.3 or the comparison criteria in DAR 15-205.6 are completely falacious and should be totally deleted. However,

that experience dictates that this fundamental concept requires judicious application and additional protection is needed in order to adequately protect the government's interests.

C. Proposed Solution

(1) Change DAR 15-205.6(a)(4) to provide that cost incurred pursuant to revisions to existing compensation plans or introduction of new plans are unallowable unless the contractor notifies and provides the government with an opportunity to review the allowability of the changes either prior to or within a reasonable period after implementation.

(a) The recently approved revision to DAR 15-205.6 contains a similar notification and review requirement. If a contractor fails to comply with this requirement, no presumption of allowability exists. Needless to say, the intent behind this requirement is to assure that the government is promptly notified of major compensation related changes and given an opportunity to review these changes in a timely manner. Recognizing the government's responsibilty to perform a timely review given an opportunity, this language contains an implied presumption of allowability should the government fail to fulfill its review responsibility within a reasonable time period.

(b) While we agree with the underlying intent, it is our judgment that more substantive protection should be provided to the government. It is important that the government be cognizant of contemplated and actual changes in the contractor's compensation system. During the DAR XV, Part 2 Subcommittee's deliberations on DAR Cases 78-42 and 79-94, HQ AFCMD suggestion that prior government notification and review be made a prerequisite of cost allowability was rejected on the basis that it might be impractical to perform a review prior to implementation in some situations. Upon reflection, the subcommittee was pro~~bably~~ correct. However, we believe that the estalishment of a strict allowability test in connection with the above stated requirement does not constitute an unreasonably harsh requirement.

(c) In addition, the remedy in subparagraph (a)(4) as drafted is inconsistent with our concept that there should be no presumption of allowability. Admittedly, the government has a responsibility to take timely action. On the other hand, we do not believe that the creation of an implied presumption of allowability is necessary in order to protect contractors from inequitable treatment. Existing doctrines of estoppel are adequate in this regard.

(2) Change DAR 15-205.6(b) to provide a three-part conjunctive test wherein failure to conform generally with firms of the same size, firms in the same industry, and firms in the same geographical area will support a finding of unreasonableness.

(a) The current three-part alternative test prevents the government from being able to consider all relevent criteria since satisfying any one of the the three parts is sufficient to demonstrate the reasonableness of the contractor's expenditures. For example, while a contractor may pay its hourly personnel at a rate which doubles that being paid by other firms in the local area, its compensation is still reasonable if its wages are not out of line with the national average in its industry. Consequently, the government cannot require a contractor to take advantage of prevalent wage rates in it local area. If a contractor is located in a low cost area, DAR should require that the advantages attendant to such a location be reflected in the costs charged to government contracts.

(b) Of course, contractors are periodically confronted with situations where qualified personnel are not available in the local market and national recruiting is necessary. Under these circumstances, the fact that the contractor's compensation exceeds local standards is a non sequitur. The government should have the option and responsibility to weigh all potentially relevant facts and challenge the reasonableness of the contractor's compensation if and when the contractor fails to prudently contain costs.

(3) Change DAR 15-205.6(b) to clearly state that there is no presumption of reasonableness and, upon challenge by the government, the contractor has the burden of proving the reasonableness of the compensation in question.

(a) The revised language recently approved by the DAR Council is silent with regard to the presumption of reasonableness. To prevent the ASBCA and courts from continuing to recognize this presumption, it is imperative that the regulation expressly states that no presumption exists.

(b) The recently approved language states that in questionable cases, the contractor has the responsibiltiy of supporting the reasonableness of the compensation being challenged. While we believe it was the intent of the DAR Council to reverse the burden of proof, we suggest that a more explicit statement is required. The phrase "in questionable cases" is sufficiently ambiguous to create controversy with regard to which party has the burden of proof. To illustrate, the ASBCA or court may arrive at the conclusion that the mere fact that the government challenges a particular aspect of the contractor's compensation plan may not be sufficient to establish the existence of a "questionable" case.

(4) It goes without saying that the above recommended changes represent a significant deviation from past policy and will be fiercely resisted by industry. However, we are firmly convinced that such a departure from our traditional modus operandi is dictated by the serious cost growth problems that

confront the defense community. Substantive steps must be taken to introduce cost discipline into defense contracting if we are to be able to maintain a viable defense posture in the future. The recommended revisions to DAR 15-205.6 are attached.

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Proposed revisions to
15-205.6(a)(4)(b), (b),
(d) and (f)(1)

Proposed Revision to DAR 15-205.6(a)(4)

(4) No ~~presumption of allowability will exist where~~ major [Compensation costs arising from material] revisions of existing compensation plans or new plans ~~are,~~ introduced by the contractor~~,~~ ~~and~~ [are unallowable unless:] (i) the contractor ~~has not notified~~ [notifies in writing] the cognizant ACO of the changes either prior to their implementation or within ~~a reasonable period~~ [30 calendar days] after their implementation; and (ii) the contractor ~~has not provided~~ [provides] the Government, either before implemetation or within a ~~reasonable period~~ [60 calendar days or another agreed to period] thereafter, an opportunity to review ~~the allowability of~~ the changes.

Proposed Revision to 15-205.6(b)

CHANGE: 15-205.6(b)

(b) Reasonableness. ~~(CWAS) Compensation for personal services will be considered reasonable if the total conforms generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area for similar services or work performed. This does not preclude the government from challenging the reasonableness of an individual element of compensation where costs are excessive in comparison with compensation paid by other firms of the same size, same industry, or in the same geographic area for similar services. In the administration of this principle, it is recognized that not every compensation case need by subjected in detail to the above tests. The tests need by applied only when a general review reveals amounts or types of compensation which appear unreasonable or unjustified. In questionable cases, the contractor has the responsibility to support the reasonableness of the compensation in relation to the effort performed. Compensation costs under certain conditions give rise to the need for special consideration. Among such conditions are the following~~: [Total compensation paid or accrued to each employee must be reasonable. In determining reasonableness, the government should consider and weigh all potentially relevant facts. Depending upon the circumstances, facts which may be relevant include, but are not limited to, the history of the industry in question, the organizational history of the contractor, compensation policies of other firms of the same size, compensation policies of other firms in the same industry, compensation policies of other firms in the same geographic area, and the extent to which compensation paid by the contractor exceeds that paid by firms engaged in predominantly non-government work. The government may challenge the reasonableness of the total compensation paid or accrued to particular employees or classes of employees or any individual element of compensation. There is no presumption of reasonableness and, upon challenge by the cognizant contracting officer, the contractor shall bear the burden of proving by preponderance of the evidence the reasonableness of the compensation in question. It is recognized that not every compensation case need be subjected to a detailed review. A detailed evaluation of all relevant facts need only be performed when a general review reveals amounts or types of compensation which appear unreasonable or unjustified. However, compensation paid or accrued in situations such as, but not limited to the following, will be subjected to close scrutiny by the government:]

CHANGE: 15-205.6(b)(1):

(1) (~~CWAS NA~~) [Situations involving] compensation to owners of closely held corporations, partners, sole proprietors, or members of their immediate families, or to persons who are contractually

committed to acquire a substantial financial interest in the contractor's enterprise. Determination should be made that salaries are reasonable for the personal services rendered rather than being a distribution of profits. Compensation in lieu of salary for services rendered by partners and sole proprietors will be allowed to the extent that it is reasonable and does not constitute a distribution of profits. For closely held corporations, compensation costs covered by this subparagraph shall not be recognized in amounts exceeding those costs which are deductible as compensation pursuant to the Internal Revenue Code and regulations thereunder.

CHANGE 15-205.6(b)(2):

(2) ~~(CWAS-NA) Any~~ [Situations where there has been a] change in a contractor's compensation policy resulting in a substantial increase in the contractor's level of compensation, particularly when it was concurrent with an increase in the ratio of government contracts to other business, or any change in the treatment of allowability of specific types of compensation due to changes in government policy. ~~No presumption of reasonableness will exist where major revisions of existing compensation plans or new plans are introduced by the contractor, and (i) the contractor has not notified the cognizant ACO of the change either prior to their implementation or within a reasonable period after their implementation, and (ii) the contractor has not provided the government either before implementation or within a reasonable period thereafter, an opportunity to review the reasonableness of the changes.~~ [(See 15-205.6(a)(4).)]

CHANGE: 15-205.6(b)(3):

(3) ~~(CWAS-NA)~~ [Situations in which] The contractor's business is such that its compensation levels are not subject to the restraints normally occurring in the conduct of competitive business.

CHANGE: 15-205.6(b)(4):

(4) ~~(CWAS-NA)~~ [Situations in which] The contractor incurs costs for compensation in excess of the amounts which are deductible under the Internal Revenue Code and regulations issued thereunder.

Proposed Revision to 15-205.6(d) and (f)

CHANGE: 15-205.6(d):

(d) Salaries and Wages ~~(CWAS)~~ Salaries and wages for current services include gross compensation paid to employees in the form of cash, stock (see 15-205.6(f)(2) regarding valuation), products, or services; and are allowable. [(but see 15-205.6(a)(4) and (5).]

CHANGE: 15-205.6(f)(1):

(1) Incentive compensation for management employees, cash bonuses, suggestion awards, and incentive compensation based on production, cost reduction, or efficient performance, are allowable, [(but see 15-205.6(a)(4) and(5),] provided the awards are paid or accrued pursuant to an agreement entered into in good faith between the contractor and the employees before the services are rendered, or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment and the basis of the award is supported.

MEMORANDUM TO THE DIRECTOR, DAR COUNCIL

I. Problem

DAR 15-205.6(f) and (k) permit the reimbursement of bonuses and incentive compensation for management employees so long as (1) the overall compensation to these individuals is reasonable in amount, and (2) it is paid pursuant to an agreement or established plan. These DAR sections do not require that such awards be predicated on an assessment of the recipient's job performance. As a result, the government can be placed in the position of reimbursing the cost of some awards which are either based on ambiguous, subjective criteria, or measures which are totally unrelated to the recipient's individual productivity. In such cases the inducement value of the award is either totally lost or substantially diminished. It is inappropriate for the government to reimburse the cost of additional executive compensation which is not directly related to the quantity and quality of the services rendered by the managerial employee.

II. Recommendation

DAR 15-205.6(f) and (k) be revised to stipulate that the cost of bonuses and incentive compensation paid to management employees is allowable provided that the award is predicated on the degree to which the recipient satisfied pre-established performance goals.

III. Discussion

The cost associated with executive bonus and incentive compensation plans has become sizeable over the years. According to a survey of eighteen (18) contractor locations under AFCMD administrative cognizance, the average, individual cash bonus paid to the highest paid eleven (11) executives at the division level in 1980 was $46,000. When one considers the cost of other types of incentive compensation (stock bonuses, stock appreciation rights, etc.), and the total universe of managerial employees eligible for such awards, the figure is extremely significant. In light of the above, it is imperative that these plans be structured so as to maximize the underlying incentive to the greatest extent possible. As currently written, DAR is inadequate in this regard. In the subsequent paragraphs, we have attempted to further define the problem and set forth an appropriate solution.

A. Backround

1. There are three (3) sections of DAR 15-205.6 that specifically address executive bonuses and incentive compensation. These sections are as follows:

a. DAR 15-205.6(a)(1), General

b. DAR 15-205.6(f), Bonuses and Incentive Compensation

c. DAR 15-205.6(k), Deferred Compensation

Prior to Revision No. 50, 2 November 1959, the coverage of executive compensation expense in DAR (then ASPR) was limited to a listing of different types of compensation and a statement that an individual's compensation may be questioned and the amount limited so long as consideration is given to the relationship of the total compensation to the services rendered (ASPR 15-204(c)). Revision No. 50 introduced the three (3) sections cited above, and for the purposes of this discussion, these sections have remained substantially unchanged.

2. DAR 15-205.6(a) defines "compensation" and with certain caveats , states that compensation costs are allowable to the extent that the total compensation of an employee is reasonable for the services rendered. Of particualr interest is the fact management employee incentive compensation plans are identified as a separate type of compensation distinguishable from bonuses and incentive pay applicable to the employee at large.

3. DAR 15-205.6(f) covers the allowability of awards paid in the period that the related services were rendered. It supplements the general allowablility criteria set forth in DAR 15-205.6(a) by stipulating that such costs must be paid pursuant to an agreement or established plan. DAR 15-205.6(k) covers deferred awards.

B. Problem

1. The fact that DAR does not require that bonuses and executive incentive compensation be based on job performance is well established. The pertinent language in DAR 15-205.6(f) is as follows:

> "Incentive compensation for management employees, bonuses, suggestion awards, safety awards, and incentive compensation based on production, cost reduction, or efficient performance, are allowable . . ."

In the Bell Helicopter Case (65-1 BCA 4865), the government questioned the cost of an executive incentive compensation plan wherein awards were based solely on the company's return on net worth. Eligible employees automatically received an award so long as the company recognized a positive return. The recipient's individual job performance was essentially irrelevant. The government argued that the words "based on production, cost reduction, or efficient performance" modify all of the types of compensation set forth in this DAR section. The ASBCA rejected this argument on two bases. First, the government's reading of the relevant language was illogical. Second, it is well-recognized that key management personnel are primarily concerned with policies and procedures and their performance can only be reflected in the overall performance of the business. According to the Board, this last position is supported by DAR 15.205.6(a) where management employee incentive plans are distinguished from other incentive awards.

2. In a recent case (Burt Associates, 82-1 BCA 15764), the ASBCA addressed the issue of the incentive value of cash bonuses. It was the government's contention that the cost of the bonus in question was unallowable since the bonus was not required for incentive purposes. The Board did not concur with the government's position. The Board noted that the "necessity" for paying a bonus to spur incentive is not the test for allowability of bonus payments. In fact, the Board went further and indicated that "incentive" does not have to be the purpose of the payment. Consequently, we are confronted with a situation where bonuses and incentive compensation paid to management employees do not have to be based on personal performance.

3. Before directly addressing the problem at hand, a few remarks concerning these cases are appropriate. While we concur that the current DAR language cannot be logically interpreted as requiring that all awards must be based on job performance, we do not agree with the Board's statement in the Bell case that the performance of key officials can only be reflected by general measures of the performance of the overall business. In our opinion, more discrete criteria can and should be developed. At a minimum, even if general business measures are utilized to define the size of the bonus/incentive compensation pool, specific goals that fall within the individual's scope of responsiblility should be established and the awards to key executives based on the degree to which these objectives are satisfied or exceeded.

4. The decisions in the above cited cases leave the government in a very precarious position. We are faced with a two-fold problem. First, it is currently required that the government reimburse awards which are not directly related to job performance (given that total compensation is reasonable, etc.). And yet, what possible benefit is derived from the payment of such additional compensation? We submit that recognition of outstanding achievements and encouraging peak productivity/efficiency are the only fundamentally sound reasons for providing this type of compensation. If the sole purpose for making these payments is to attract and retain capable personnel, the objective could more easily be accomplished be merely increasing the base wage or salary. The only benefit derived

from bonuses and executive incentive compensation is the resulting incentive to perform in an outstanding manner. It defies common sense for the government to reimburse awards which are not directly related to job performance.

5. Second, assuming that bonuses and executive incentive compensation are based on job performance, there is no requirement that the contractor's plan contain discrete assessment criteria. Awards based solely on broad, subjective assessment criteria can actually decrease rather than increase productivity. When potential recipients do not have a clear understanding of how the number and size of awards are to be determined, frustration results and performance can be negatively impacted. Eligible employees must know exactly what is expected of them in order to receive a bonus or incentive award.

6. A survey of the corporate locations under AFCMD administrative cognizance indicates that all of compensation plans are related, to a certain extent, with job performance. However, the degree to which these plans entail verifiable performance standards and goals varies significantly. To illustrate this point, we have summarized the assessment criteria of two senior executive compensation plans currently in use at two AFCMD locations.

Plan I

- The size of the incentive pool is determined by the degree to which the corporation satisfies specified corporate goals (e.g., actual versus planned operating margin, actual versus target return on shareholders' equity, etc.). The amount placed in the pool can vary from zero to twice the guideline amount depending upon the performance assessment described above. The maximum amount of the pool is limited to no more than a specified percentage of adjusted gross margin.

- The compensation committee and the Chief Executive Official (CEO) establish six (6) to eight (8) discrete performance objectives for each participant. The Executive Committee sets similar objectives for the CEO. A guideline award (a percentage of base salary) is specified in the plan.

- The participant's performance against these performance objectives is assessed. Depending upon the participant's overall performance assessment (e.g., consistently exceeded objectives, consistently failed to meet objectives, et.), the guideline award is adjusted upwards or downwards by an amount specified in the plan.

(Note: The plan states that performance evaluations should sharply differentiate among participants. If most participants receive similar awards, the plan will not be perceived as a reward for individual performance, but rather as a form of profit sharing.)

Plan II

- o The size of the incentive pool is determined by the Executive Committee. The pool cannot exceed a specified percentage of net earnings.
- o The Executive Committee selects the recipients and the amount of the awards. The plan provides the following factors as a guide to making these determinations:
  - Contribution by the employee beyond normal responsibilities relating to efficiency of operation and improvement of policies, procedures and standards.
  - Exceptional services advancing the enterprises and goals of the company.
  - Period of continuous employment.
  - Amount of salary.
  - Reasonableness of total compensation.
  - Employment for the full year for which the award is made.
- o Full power and authority to construe, interpret and administer the plan is vested in the Executive Committee.

The essential difference between these two plans is obvious. Plan I constitutes an objective MBO plan with dollars attached. Conversely, Plan II contains some very broad assessment criteria and gives the Executive Committee considerable latitude to exercise its subjective judgment as to the size of the incentive pool and the amounts awarded to individual participants. The formal provisions of Plan II provide little or no assurance that the size of the individual awards will have any discernable relationship with the recipient's actual job performance.

7. This is not to say that bonus and executive incentive compensation plans must be structured so as to eliminate all subjective judgment. It goes without saying that the evaluation of executives, especially top management officials, will always require a certain amount of subjective assessment. This is even true of Plan I which emphasizes objective criteria to the maximum extent possible. On the other hand, to assure that these plans do in fact provide incentive, DAR should mandate that such plans require that discrete performance goals be established and awards be based on a discrete assessment of the recipient's performance in relation to these goals.

[illegible] Proposed Solution

In light of the foregoing, we recommend that DAR 15-205.6 be revised to require that the payment of all bonuses and executive incentive compensation be based on a plan or agreement which mandates (1) the establishment of performance objectives and(2) that the size of awards will be determined by discrete assessment of the recipient's performance in relation to these objectives. Our proposed DAR language is attached.

Proposed Revision to DAR 15-205.6(f)

(f) Bonuses and Incentive Compensation.

(1) Incentive compensation for management employees, cash bonuses, suggestion awards, safety awards, and incentive compensation based on production, cost reduction, or efficient performance, are allowable; Provided, the awards are paid or accrued pursuant to an agreement entered into in good faith between the contractor and the employees before the services are rendered, or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment, and the basis for the award is supported. [Bonuses and incentive compensation exclusively applicable to management employees must be based on an assessment of the individual employee's performance in relation to preestablished individual, department, and corporation performance goals or objectives.]

(2) When the costs of bonuses and incentive compensation are paid in the stock of the contractor or of an affiliate, the following additional restrictions are applicable:

(i) Valuation placed on the stock shall be the fair market value on the measurement date (i.e., the first date the number of shares awarded is known) determined upon the most objective basis available; and

(ii) Accruals for the cost of stock prior to the issuance of such stock to the employees shall be subject to adjustment according to the possibilities that the employees will not receive such stock, and their interest in the accruals will be forfeited.

(3) When the bonus and incentive compensation payments are deferred, the costs are subject to the provisions of (1) above, and the requirements of (k) below.

Proposed Revision to DAR 15-205.6(k)

(k) Deferred Compensation.

(1) Deferred compensation is an award given by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods prior to the date of receipt of compensation by the employee. Deferred compensation does not include the amount of year-end accruals for salaries, wages, or bonuses that are paid within a reasonable period of time after the end of a cost accounting period. Subject to paragraph (a) of this cost principle, deferred awards are allowable when they are based on current or future services.

(2) The costs of deferred awards shall be measurd, allocated, and accounted for in compliance with the provisions of CAS 415, Accounting for the Cost of Deferred Compensation.

(3) Deferred compensation payments to employees under awards made prior to the effective date of CAS 415 are allowable to the extent they would have been allowable under 15-205.6, dated 1 July 1976.

[(4) Deferred bonuses and incentive compensation awards exclusively applicable to management employees must be based on an assessment of the individual employee's performance in relation to preestablished individual, department, and corporation performance goals or objectives.]

MEMORANDUM FOR DIRECTOR, DAR COUNCIL

SUBJECT: Employee Termination Plan Payments

I. PROBLEM:

Recently, in order to avoid or hinder merger or takeover attempts, some companies with the approval of the Board of Directors, and in some cases stockholders, are providing key executives with excessive severence pay benefits. These payments have been referred to in newspaper articles as "golden parachutes". The language of DAR 15-205.6(g) needs to be revised to specifically address these excessive payments. Additional background is provided in Tab 3.

II. RECOMMENDATION:

That 15-205.6(g) be revised to make these excessive severance payments expressly unallowable.

III. DISCUSSION:

DAR 15-205.6(g)(2)(i), Severence Pay, states in part: Severance pay is allowable only to the extent that in each case it is required by (A) law; (B) employer-employee agreement; (C) established policy that constitutes, in effect, an implied agreement on the contractor's part; or (D) circumstances of the particular employment.

In our opinion, this language is sufficiently broad to permit allowance of these excessive payments under either (B), (C), or (D). The severance payments involved usually are:

- well in excess of the contractor's normal severance payments.
- offered to a limited number of key executives
- normally paid only in the event of dismissal due to a merger or takeover
- normally not earned by the employee over his/her years of service

While an argument can be presented that these excessive payments represent organizational costs unallowable per DAR 15-205.23, the issue is far from conclusive. In some cases, a significant change in stock ownership can trigger the "golden parachute" without any merger taking place. Additionally, contractors will argue that these executive termination agreements are necessary to maintain and hold competent people.

The preliminary information gathered by the Defense Contract Audit Agency indicates that these payments were material at UTC and Bendix as follows:

UTC		
Chief Executive Officer		$ 3 million
63 Executives		41 million
	Total	$44 million*

* Basically, under the UTC plan the executive is paid three times his/her annual salary. The executives also receive additional benefits such as accelerated vesting of pension plans and the bonus or other benefits they would have received if they were still working for three years. No estimate is available for these additional benefits.

Bendix		
Chief Executive Officer		$ 4,700,000
22 Employees (16 officers & 7 non-officers)		$11,000,000
	Total	$15,700,000

Under Bendix's plan, the chief executive officer's severance payment is five times his annual salary plus bonus. For all other executives the calculation is based upon three times annual salary plus bonus. Bendix, like UTC, also provides additional benefits like pension vesting, etc. No estimate available for these additional benefits.

IV. CONCLUSION: The suggested change in Tab A is recommended as an addition to DAR 15-205.6(g).

15-205.6 (g)(3) Employee Termination Payments

[(3) Employee Termination Payments

(i) Employee termination plans payments, sometimes identified as "Golden Parachutes" include, but are not limited to, certain cost incurred by a contractor as a result of employment agreements with an employee. Such agreements provide that if there is a change in the control of the management and/or ownership of the contractor and the employee is dismissed, terminated or leaves as a result, the employee shall receive certain compensation upon dismissal or termination of employment. Such employee termination payments are usually:

(A) well in excess of the contractor's severance payments and/or practices for other types of employee termination; and

(B) offered to a limited number of employees.

(ii) Employee termination payments as defined herein, and all costs directly or indirectly associated with such payments, are unallowable.

Question. 2. Could you please (A) provide a list of principal contractors with which the Air Force does business, and (B) show for each one the amount of Air Force Business it has in terms of dollars (1) for FY 1983 and (2) currently in effect as of September 30, 1983. In addition, (C) state the percentage of the Air Force total contract awards for FY 1983 attributable to these principal contractors?

Answer. The table below reflects the principal Air Force contractors who received the largest value of dollars obligated under contract actions in FY 1983:

Rockwell International Corp	$3,952,184,000
Boeing Co	3,556,238,000
McDonnell Douglas Corp	2,434,576,000
General Dynamics Corp	2,130,446,000
General Electric Co	2,022,335,000
United Technologies Corp	1,853,813,000
Lockheed Corp	1,600,213,000
Martin Marietta Corp	1,002,863,000
Westinghouse Electric Corp	928,192,000
TRW Inc	828,412,000
Hughes Aircraft Co	773,815,000
Northrop Corp	618,136,000
Total	21,701,223,000

The total dollar value of Air Force contractual actions during FY 1983 was $41,428,317,000. The contractual actions with the 12 principal Air Force contractors represent 52.4% of the FY 1983 Air Force total.

Question 3. Of the principal contractors identified in question 2 above, identify the specific contractors who are not currently providing, or who at any time during your Air Force or DOD studies did not provide full access of all labor compensation data, including data relating to executive compensation?

Answer. The Air Force has experienced very little difficulty in obtaining full access to all contractor employee compensation data. To my knowledge, during the past three years, only two contractors have refused to provide full access to data. The Pratt & Whitney Government Products Division of United Technologies and the General Electric Corporation failed to provide unrestricted access to the compensation data for top level executives. In both cases, the conflict was resolved in the government's favor and full access to data was granted.

Currently, two contractors are reluctant to participate in a special compensation study which a consulting firm is performing for the Air Force Contract Management Division. Boeing is refusing to participate in the study in any way. Pratt & Whitney wishes to place restrictions on the data provided for the study. Even though contractor participation in the study is voluntary, the Air Force is working to resolve this dispute.

Question 4. The Committee discovered that DCAA auditors must make arrangements with management before making floor checks at the Hughes plant in Tucson, Arizona, the McDonnell plant in St. Louis, Missouri, and the Texas Instrument plant in Dallas, Texas. Is this the general practice at defense contractors' plants? Do you agree that this practice is inappropriate? What can the contract management personnel in the Air Force do about this problem?

Answer. To my knowledge it is not the general practice at any Air Force cognizant plant, including the Hughes plant in Tucson, to have to make advance arrangements with the contractor before performing floor checks. Such a practice would be highly inappropriate. Should a contractor wish to impose such a requirement, we would work directly with the DCAA to have this requirement removed.

Question 5. You stated during the hearing that you were generally satisfied with the contract audit reports which your procurement people were receiving from DCAA. However, the DOD Inspector General, in testimony before the Committee on March 1, 1984, cited several problems with DCAA's audit reports including the issuing of qualified reports as a result of limitations in access to records, lack of documentary support for proposed prices, significant nonconformances with cost accounting standards, etc. In fact as many as 80 or 90% of the DCAA reports on pricing proposal reviews are qualified in some respect. Under the circumstances, on what basis do you judge the adequacy of DCAA's audit work and its service to Air Force procurement personnel to be effective? Do you believe qualified audits are useful to procurement personnel and can they be used to judge whether or not a contract proposal is reasonably priced? Aren't the procurement personnel in the Air Force at least partly responsible for the fact that auditors have trouble gaining access to records and have to issue so many qualified reports?

Answer. We judge the adequacy of an audit report based on its ability to support us in obtaining fair and reasonable prices for the goods and services which we acquire. An audit report will help us achieve this goal if it is logical, based on quality analysis, timely, and can withstand legal challenge.

Audit reports do frequently contain qualifications. However, the vast majority of these qualifications are minor in nature and simply reflect the prudence which any good analyst should demonstrate. Sometimes audit reports contain significant qualifications. These qualifications may result from time constraints or, in a limited number of cases, from access to records problems. The impact of a qualified audit report upon negotiations depends upon the nature of the qualification. If the qualification is such that it casts doubt on our ability to determine a reasonable contract price, then negotiations must be suspended until the problem is corrected.

We have not had a chance to examine the unreleased report upon which the DOD/IG testimony was apparently based. However, we are not aware of widespread access to data problems within the Air Force acquisition community. Our experience has been that when access to data problems occur, we are usually able to correct the problem and get whatever records we need.

In cases where access to records problems do exist, Air Force contracting personnel should support the auditor to the fullest extent. If the contracting officer concludes that a problem of material consequence exists, then the problem should be forwarded up the chain of command as far as necessary to obtain satisfactory resolution. we feel that our contracting officers understand the proper procedures for resolving access to records problems and have been very successful in utilizing them.

Question 6. As you are aware, the DOD Inspector General recently issued a report on his review of audits and other field pricing evaluations of subcontractors' pricing proposals. (Report Number APO 84-3, dated January 16, 1984). Would you advise the Committee, given the results of the report and its relevance to the operations of your office, what actions you have taken and will be taking to correct the deficiency conditions contained in the report? Do you agree with the findings of the report and if not, why not? Please be specific.

Answer. Subcontract costs constitute a very large part of the total cost of a typical major system contract. For this reason, we support the general thrust of the audit report that proper subcontract pricing is imperative. However, the report's findings about two specific Air Force contracts were extremely misleading.

The two Air Force contracts discussed in the report were the Lot IX buy of the F-100 engine and the Option VIII buy of the A-10 aircraft. The primary allegation in both cases was that the contracts were negotiated without obtaining proper pricing analysis of subcontracts. Our own analysis of these two contracts resulted in contradictory findings. We found that proper pricing analysis, as required by DAR 3-807, was performed in both cases.

The case of the Lot IX buy of the F-100 engine illustrates the contradictions between our findings and the findings of the DOD/IG. The DOD/IG stated that the contract was negotiated without adequate pricing of $380 Million of subcontract cost. Our analysis revealed that the lack of adequate subcontract cost and pricing data was a primary finding of an Air Force should cost review prior to negotiation. The contract negotiators recognized the problem and suspended negotiations until adequate data was obtained. Ultimately, separate DCAA audits were performed on subcontracts totaling 51% of the value of non-competitive subcontracts. Pricing analysis sufficient to satisfy the requirements of DAR 3-807 was performed on all remaining non-competitive subcontracts. Subcontracts totaling 24% of the $380 Million were obtained competitively. Thus, our analysis showed that the pricing of all subcontracts was very thorough.

While our findings differed with those of the DOD/IG with regards to the adequacy of pricing, and other issues, we have taken actions which support some of the recommendations of the audit report. The audit report questioned the adequacy of Pratt & Whitney's purchasing system. Air Force approval of that system has subsequently been withdrawn. The audit report questioned Air Force aggressiveness, during the late seventies, in pursuing dual sourcing for A-10 subcontractual items. Since that time, the Air Force has been very aggressive in pursuing dual sourcing opportunities. The most recent example is the very large Alternate Fighter Engine contract.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR PERCY

Question 1. At what time, under what circumstances, and at what level was the decision made not to allow Mr. Fitzgerald to testify in his official capacity at the Committee hearing on March 1st?

Answer. The Secretary of the Air Force made the decision on 29 Feb that while Mr. Fitzgerald could, and was encouraged to, testify in his own capacity, he could not testify as an official Air Force witness. I am informed that, at the request of Senator Roth, the Inspector General of the Department of Defense has investigated this matter and furnished a report of the investigation to the Committee.

Question 2. I would like to hear any comments you might have in response to any of the eleven questions I am asking Mr. Fitzgerald.

Answer. I would prefer not to comment on questions directed specifically to Mr. Fitzgerald. However, I believe I have already provided the committee with answers to many of these questions.

Question 3. Some time ago, I asked the Air Force for an official response to several allegations made about practices at the Hughes Aircraft Plant in Tucson. I received a response last week indicating that the allegations regarding other work being done at the plant were totally inaccurate and untrue. To my knowledge, the Air Force did not investigate the matter, and the FBI still has an investigation pending. What basis do you have for saying that these allegations are untrue?

Answer. The Air Force is aware of two formal investigations into illegal construction of Home Box Office (HBO) receivers at the Tucson plant. The Tucson Police Department completed their investigations and concluded that HBO receivers were not being produced at the Hughes facility, nor was there any evidence of pilferage of parts or material from Hughes to make the receivers elsewhere. The FBI is also conducting an investigation of HBO construction at Hughes. Although this investigation is not complete, the Air Force understands that the FBI has come to the same conclusion as the Tucson police. Hughes has stated that in 1981 there was an incident of HBO construction during employees lunch time. Hughes management detected and stopped this activity, and took action against those involved and their supervisors.

Pilferage of precious metals at Hughes was another allegation. Very little precious metal is used at Hughes, mostly gold ink and chemicals for plating. During October and again in November 1983, the Air Force conducted a review of the Hughes material control record system. This review, while not an audit, did show the control system was proper and working. The Air Force has no information that substantiates these allegations of pilferage.

Question 4. The 1978 Ethics in Government Act gave executive agencies the power to take administrative action against those who violate the conflict of interest statutes. To my knowledge, however, the Air Force has not taken any action against a single present or former employee in the six years since this bill was passed. Why is this?

Answer. The Air Force, like all federal agencies, has always had the authority to take administrative action against its current employees and active duty members for violations of any laws and regulations regarding conflict of interest. The 1978 Ethics in Government Act added subsection (j) to 18 U.S.C. 207, which provided a new administrative remedy covering former officers and employees who violate 18 U.S.C. 207 (a), (b) or (c). This provision states that after notice and opportunity for hearing, an agency head may prohibit a former officer or employee who is found to have violated 18 U.S.C. 207 (a), (b) or (c) from certain representational activities before the agency on a pending matter of business for a period not to exceed five years, or the agency head may take other appropriate disciplinary action. Implementing procedures to carry out this provision have been developed by the Office of Government Ethics and DoD. The Air Force has not taken action against former officers or employees under this section because in the judgment of commanders and their legal advisors there have not been appropriate cases under the terms of the statute and implementing procedures.

In this connection, the Air Force does make a strong effort to prevent violations of 18 U.S.C. 207 from occurring by informing departing officers and employees of the restrictions applicable to them and by informing current officers and employees not to conduct business with former officers or employees who might otherwise inadvertently violate the statute.

Question 5. I have obtained approximately 200 postemployment forms for present Hughes Aircraft employees who once worked as civilian or military employees of the Defense Department. According to these forms, it appears that many worked on very similar projects inside and outside the government. Have you ever inquired into whether any of these individuals may have negotiated for a future position with Hughes Aircraft while still exercising Defense Department responsibilities? Do you plan to undertake such an investigation?

Answer. We have no information to indicate that any former officer or employee now employed by Hughes Aircraft has violated 18 U.S.C. 208 by participating in a particular matter in which Hughes Aircraft had a financial interest while also negotiating with Hughes Aircraft for prospective employment. Our standards of conduct regulation clearly prohibits such activity and requires that individuals disqualify themselves from participating in matters in which their possible prospective employer has a financial interest. We would investigate (or refer to the appropriate investigative agency) any credible allegations or other evidence of this nature against officers or employees. We do not conduct investigations merely because post-employment reporting forms (DD Form 1787) show that a former officer or employee now works for a defense contractor. No investigation is contemplated of all Hughes Aircraft employees who formerly were Air Force members or employees.

Chairman ROTH. The committee is in recess.

[Whereupon, at 11:33 a.m., the committee adjourned to reconvene at the call of the Chair.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

DEPARTMENT OF THE AIR FORCE

STATEMENT OF

A. ERNEST FITZGERALD
MANAGEMENT SYSTEMS DEPUTY
OFFICE OF
THE ASSISTANT SECRETARY OF THE AIR FORCE
(FINANCIAL MANAGEMENT)

ON

Oversight of the Roles and Missions of the Defense Contract
Audit Agency (DCAA)
For Presentation to
The Committee on Governmental Affairs
United States Senate

March 1, 1984

MR. CHAIRMAN - MEMBERS OF THE COMMITTEE:

Your staff has suggested that my testimony would be most helpful if I would concentrate on my recent experiences with the contract auditing functions, mostly the Defense Contract Audit Agency (DCAA).

Since my return to the acquisition cost control business in 1982, my areas of interest most directly affected by DCAA operations have been (1) contractor labor rates, and (2) contractor labor distribution.

In the first instance -- that of labor rates -- my interest was stimulated by a March 1982 telephone call from Mr. George Spanton, DCAA Resident Auditor at Pratt & Whitney in West Palm Beach, Florida. Mr. Spanton told me at that time that, in his opinion, we had an opportunity to save hundreds of millions of dollars, perhaps billions, by holding down rates of increases in contractor employee compensation. He explained that a typical practice was to extrapolate statistically past trends of rates of pay in projecting allowable rates for the future. This practice tends to perpetuate mistakes and poor stewardship of the past. It does not give adequate weight to market place forces which the Department of Defense can influence if it chooses to do so.

Mr. Russell Hale, Assistant Secretary of the Air Force for Financial Management, commented on this in an interview published in the New York Times on November 13, 1983, using my statement that the future extrapolation of historical past costs leads to huge continuing cost increases. He said, "We have got to get away from measuring actuals. The contractors love us to do that. That's crazy."

Mr. Spanton said that he and his staff were trying to break out of the costly, illogical patterns of the past in examining Pratt & Whitney's employee compensation proposals. He said that he and his staff had made an analysis of Pratt & Whitney's wage and salary projections and had made recommendations which he claimed would save about $150M at one division of Pratt & Whitney over the next three years, simply by moderating the rate of projected increases. Unfortunately, Mr. Spanton said, the "procurement community" was then vigorously opposing his proposals. Our discussion revealed that the so-called "procurement community" which was objecting to Mr. Spanton's study consisted of the contractors, the military buyers, the contract administrators, and senior managers of the DCAA.

I asked Mr. Spanton for a copy of his proposal. He declined to send me a copy directly. He said that the matter was "extremely sensitive" and that he would appreciate my trying to get his report from other sources.

I was not able to get a copy of Mr. Spanton's report until June 8, 1982. On that date, I was visiting the Air Force Contract Management Division (AFCMD) of the Air Force Systems Command at Albuquerque, New Mexico. I asked for and received a copy of the now famous Spanton Labor Report. However, I was told by CMD officials that the report had been withdrawn. Indeed, the copy I received (Encl 1) had written across it "This report was withdrawn by DCAA!!."

When I returned to the Pentagon, I showed the Spanton report to one of my associates who told me that Mr. Spanton's analysis supported Secretary of the Air Force Verne Orr's own conclusions on the subject. My associate gave me a copy of a memorandum Mr. Orr had written on April 15, 1982 (Encl 2) which read as though it could have been written by Mr. Spanton. Mr. Orr's conclusions were based in part on studies done within the Air Force which showed that aerospace wages had increased much faster than wages in the operations of U.S. manufacturers generally.

A report by the Air Force Comptroller's Directorate of Management Analysis and AFCMD, summarized by the Air Force Deputy for Aerospace Economic Analysis, shows that: In 1970, aerospace labor rates were 24% above the Bureau of Labor Statistics "all manufacturing" rate; by 1981 that gap widened to 38%. Again, aerospace rates in 1970 were 22% above rates for all "durable goods workers"; by 1981 that gap had widened to 39%.

Examined on a geographic basis, aerospace wage rates exceeded area averages by 25% in 1981. Increases in aerospace wages exceeded inflation throughout the period. Our greatest concern, however, was the fact that executive and mid-management levels of compensation were much higher than the "blue collar" rates. We also believed aerospace management compensation rates to be higher than in non-aerospace industries generally. In some of our larger contracting activities, the highly-paid white collar engineering staffs outnumber the blue-collar. In one particular plant, for example, hourly-rate, blue-collar people are less than 20% of the work force, while engineers constitute more than 50% of the total employees.

I noted that the Air Force studies dealt only with hourly wages. Fortunately, Mr. Spanton's study dealt with salaries as well as hourly wages.

On further inquiry, we found that the Spanton labor report had not really been withdrawn but, instead, had been reissued with essentially the same factual findings but with changes in the introductory language. We also found that Mr. Spanton's proposal was every bit as controversial as he had described it the previous March. The "procurement community" was focusing on attacking the Spanton report rather than on implementing Mr. Orr's guidance. Due no doubt to Mr. Orr's high level of authority, the "procurement community", rather than trying to refute or attack Mr. Orr's direction openly, was simply trying to ignore it. Despite explicit directions to communicate his guidance and direction widely, Mr. Orr's April 15, 1982 memorandum had not been officially transmitted to the affected field offices.

By early July 1982, the Orr initiative was given new life by mating it with the Spanton labor report. Mr. Spanton's report confirmed in a specific instance the practicality of Mr. Orr's general direction. Two of my associates, Mr. Colin Parfitt and Mr. Jim Ririe, visited Pratt & Whitney's West Palm Beach plant in July of 1982 and found that Mr. Spanton had been conservative in his analyses and his proposals. Mr. Parfitt wrote several reports which, in my opinion, moved the whole contractor compensation issue off dead center. Copies of these reports are included in Enclosure 3.

As a result, our management immediately issued instructions to the Air Force Headquarters staff and the commands to discontinue mechanical extrapolation techniques, which amount to "cost justification", and to make greater use of analyses aimed at saving money.

The Secretary of the Air Force, Mr. Orr, emphasized repeatedly his desire that we not focus entirely on hourly wages, but instead challenge other compensation areas -- specifically, executive pay and fringe benefits. I have heard and read many attacks on the market-oriented compensation rate analyses and challengers suggested by Mr. Orr and actually done by Mr. Spanton. However, none of these negative criticisms focused on how best to save money for the taxpayers and the services. Rather, those critical of the market-oriented approach either argued that our procurement regulations did not permit such an approach, which was untrue, or sought to defend the blind statistical extrapolation approach. In particular, the GAO attacks on Mr. Spanton's attempt to save money were based on alleged inadequacies in manipulation of historical statistics.

In my opinion, Mr. Spanton and his associates have dealt adequately with the statistical criticisms. However, the argument posed by the statistical critics are mostly irrelevant to what we should be paying now or in the future for services by contractor personnel.

Although critics of the Orr/Spanton approach continue to hammer away at its viability in general, and at the "reasonableness" of Mr. Spanton's proposals in particular, the increasing rate of the upward trend established over the last few years has been broken, at least for hourly wages and for government personnel. The documents in Enclosure 4 record results realized in recent months.

Unfortunately, most of the sharply lower increases and all of the give-backs which we know about are in hourly wages. In my opinion, if we do not realize similar or greater restraint in management and all other white-collar compensation, our role in encouraging restraint of hourly wages will come back to haunt us. If it appears that we have been picking on the hourly workers exclusively, the question of fairness will arise, and justifiably so. At this time, it would be most helpful if the top management of the DCAA and other important actors on the government side of the procurement process would join in exploiting the small breakthroughs we have made, rather than denigrating and belittling the now-proven new approaches. In particular, I would welcome a strong challenge by DCAA and GAO top management to management pay and benefits which we have been allowing on negotiated contracts. If these audit organizations persist in making the illogical and costly statistical arguments for continuing wasteful practices of the past, the taxpayers would be far better off not having them around at all. The big contractors are perfectly capable of making their own arguments and don't need support from DCAA. Our already overburdened taxpayers should not have to support high-priced government bureaucrats who rely on statistical hocus-pocus to justify over-priced contractor proposals.

In connection with our efforts related to compensation rates across-the-board, the Assistant Secretary of the Air Force for Financial Management on 24 August forwarded a "Report on Compensation Benefits in the Aerospace Industry" to Secretary Orr. The report detailed results to date and ongoing actions, one of which was a request to DCAA to undertake a "Survey of Compensation Rates". A series of meetings between Air Force and DCAA personnel resulted in a draft survey plan by mid-October 1982. Our leadership in this area was undercut by Dr. DeLauer on 20 October 1982. Dr. DeLauer's memorandum of that date, reportedly based on his discussions with DCAA and procurement representatives from the Air Staff and perhaps elsewhere, placed the leadership of a "Study of Defense Industry Contractor Labor Rates" in the procurement community. The use of the term "labor rates" was extremely unfortunate due to its connotation of "blue collar, hourly-employees-only". This was not the thrust of the Air Force efforts which were directed toward compensation rates across the entire spectrum of people employed in defense contracting generally and aerospace defense contracting in particular.

Foreseeably, the DeLauer memorandum would deflect the effort we in the Air Force had initiated; and sure enough, it did. The DCAA provided an interim report to the Assistant Secretary of the Air Force for Financial Management, dated 7 January 1983, "Interim Report on DCAA Survey of Labor Costs". (Please note those words "labor costs", not compensation rates). As we had envisaged, the report dealt essentially with direct labor employees (mostly blue-collar) and was not adequate for our purposes. At this time, nearly 14 months after the interim report, we are awaiting a final report and have been informed that it would be sent to us on March 1st. We have also been informed by DCAA that with respect to our original thrust regarding compensation rates, contractors either refused to provide information or provided unuseable information. This indicates that as the culmination of more than a year and a half of work, the output by DCAA for the Air Force will be a small, round zero.

Our interest in the matter of overall compensation in aerospace industries was sharply stimulated in December 1982 when we were briefed on the results of an aerospace executive compensation review done by the Air Force Systems Command. The study showed that executive compensation in transportation equipment manufacture was 20% higher than executive compensation in all other durable goods manufacturing; however, the aerospace component of transportation was 30% above all other. The study included all major aerospace contractors, except Pratt & Whitney and Lockheed Sunnyvale. Our interest was reinforced in early spring of 1983 when we received, "over the transom", a copy of a Defense Contract Administration Services compensation review at Pratt & Whitney, West Palm Beach, that showed executive compensation at that location to be 40% above that of their peers in other aerospace corporations.

Despite the total lack of support from DCAA, our concern with overall compensation in the aerospace industry will not go away. We will have to devise ways to attack the problem without wasting further time on the DCAA.

Our attempt to make improvements in my second area of interest most directly affected by DCAA operations -- contractor labor distribution -- has been equally frustrating. In my first visit to a contractor location after I was permitted to return to acquisition cost control in 1982, I visited Hughes Aircraft Company's plant in Tucson, Arizona, with my associates, Mr. Colin Parfitt and Mr. Jim Ririe, to review cost control procedures and look for opportunities for cost reduction, primarily on the Imaging Infra Red (IIR) Maverick missile. At my request, the Air Force Plant Representative (AFPRO) produced figures for Hughes factory labor performance on their major government programs at the Tucson plant. These figures showed labor performance realizations ranging from 6% to 50% of normal, as measured by the company against its own should-take time standards. A subsequent audit of Hughes time standards by a team of Army and Air Force industrial engineers validated them as reasonably accurate on average.

In my experience, such a variation in a single factory, regardless of the stages of the various programs, signals the strong possibility of discrepancies in labor cost distribution, among other problems. Work habits and management practices tend to be much more uniform at a given location than reported at Hughes Tucson. The possibility that performance differences of such magnitude could be legitimate and unavoidable is remote. Generally speaking, human beings do not work at 6% of normal rate. They may not be working at all, they may be doing the same work several times (suggesting bad quality control), or if the management control systems permit, they may be charging their work time in accordance with whatever the traffic will bear rather than accurately to jobs actually worked on.

In order to examine controls against the latter possibility, I asked to see the employee timecards in several departments my team visited while touring the Hughes plant. In the first department we examined, the unit supervisor had in hand a stack of his employees' timecards with work orders claimed to have been worked on already on the cards, but without any times recorded. This examination took place in the middle of the afternoon -- perhaps an hour or an hour and a half before the end of the day shift. The supervisor explained that he would make the labor hour distribution himself based on what he knew about what his employees had been doing that day. This particular activity was a process operation which, if efficiently run, would mingle parts for a number of end products. Therefore, it would be illogical for either employees involved in this process or the foreman to try to associate their work time directly with intermingled parts in such a way as to distinguish time spent on one group of parts within the mass from any other. Even an inexperienced overseer should realize that the logical and "generally accepted" approach to solving such problems would be to institute some form of process cost accounting or standard cost accounting for the operation. Properly set up, such systems would make it very difficult to manipulate labor charges. To any experienced industrial engineer or cost accountant, the practices we saw of timekeeping and labor hour charging in a process operation should be the management equivalent of flashing red lights and sirens. It invites manipulation.

Amazingly, no one we talked to in the DCAA saw anything wrong with Hughes' approach to labor distribution. Moreover, they didn't seem to care.

On a later visit, one of the DCAA officials told me that the Hughe's approach to timekeeping in the process areas was illogical, but that he still couldn't see anything wrong with it. The DCAA did argue that the process operations represented such a small part of overall costs at the plant that we shouldn't worry about them. However, none of them could describe what they were doing to assure effective control of labor distribution in general.

Only in recent weeks have I learned the results of the DCAA audit growing out of my concern about labor distribution at Hughes Tucson plant. I learned about these results mostly through consultation with the committee staff.

On December 16, 1982 following a conversation Mr. Parfitt and I had with the DOD Review and Oversight (later renamed the Inspector General) representatives, the DOD IG requested DCAA to investigate our areas of concern. On February 2, 1983, Mr. Norman Warner, DCAA Senior Auditor, wrote to Mr. Arthur Grisham, Regional Audit Manager, and reported that "the risk for labor charging irregularities" was "minimal". They did not report any observed irregularities as a result of floor checks. The February 2d memorandum was forwarded on February 22 to the Deputy Assistant Secretary of Defense for

Cost and Audit by the Director of DCAA under a cover letter in which the Director reported, among other things, that "... internal weaknesses were not found ..." Both the February 2 memorandum and February 22 memorandum were forwarded to the Assistant Secretary of Defense (Review and Oversight) under another cover letter signed by the Deputy Secretary of Defense for Cost and Audit which reported "... no evidence of manipulation of timecards ..." Finally, on June 30, 1983, a formal audit report was issued over the signature of the Resident Auditor at Hughes Tucson plant which stated, in part, that "... the reported internal control weaknesses were not found to exist ..." The reports referenced above are included as Enclosure 5.

A senior member of your staff, accompaned by an Air Force Legislative Liaison officer, recently visited the Hughes Tucson plant, in part to follow up on my concerns about labor distribution. The committee staff's examination of the work papers for the audit reports I previously cited revealed that the work papers themselves presented a startingly different picture from that conveyed in the formal reports. For example, in the tiny sample of only 13 Hughes employees actually questioned:

- 5 of the 13 did not have their timecards current
- 3 of the 13 had signed their timecards in advance
- 10 of the 13 were using improper correction procedures
- 2 of the 13 stated that they performed work on jobs for which they did not have work orders
- 9 of the 13 said they "estimate" or "allocate" their labor charges to work orders rather than charge the actual time they work on each work order.

Moreover, the committee staff reports that even these results might have been biased toward "finding no evidence". The committee staff reports that the DCAA auditors consulted with the AFPRO people, requested Hughes data for the departments they were planning to review, and perhaps discussed the matter with Hughes people prior to starting work. For an unbiased picture, it is absolutely essential that floor checks be made unannounced. In short, the auditors' findings, as reflected in the notes your staff made from the work papers, do not support the conclusions stated in the audit reports. In fact, the findings are in direct conflict with the stated conclusions. I intend to follow-up this incident, but as of this writing the DCAA was continuing to refuse repeated Air Force requests for copies of the work papers reviewed by the committee staff.

I believe the committee is entitled to draw adverse inferences from the DCAA's refusal to furnish the work papers.

As illustrated in the exchange of correspondence included as Encl 6, we have not restricted our interest in contractor labor distribution to Hughes. Our Assistant Secretary for Financial Management, Mr. Hale, wrote to the Director of DCAA on April 28, 1983, expressing concern about labor mischarging in contractor operations, pointing out the possibilities for improved controls through use of work measurement to synthesize standard cost distribution (a superior cost accounting method from the standpoint of controlling mischarging, especially if coupled with good cost control), and requesting copies of DCAA audit reports for the previous two years dealing with the labor hours/cost distribution problem. The DCAA Director's May 13, 1983, response to Secretary Hale was a masterpiece of bureaucratic evasion. After seeming to share Mr. Hale's concern about the possibility of contractor labor distribution problems, the Director went on to display a profound misunderstanding of how work measurement could provide the basis for auditable checks to discourage, preclude, or at least help detect mischarging. After many years of struggling with this problem, I am still not sure whether this seeming lack of understanding on the part of professional auditors is real or contrived. As I indicated in my testimony on the Hughes Tucson situation, the auditors at that location seemed not to understand any method of labor distribution other than direct charge timekeeping. On the other hand, hostility toward commercial-type standard cost accounting for labor distribution purposes in high DOD financial circles has persisted for at least ten years, even amongst those officials who should understand the utility of the approach in controlling "cross-charging", as the practice is called in the defense industry. I am now beginning to wonder if "someone up there" might want to be a little easier on "cross-charging" than I think proper.

This latent suspicion is strengthened by the DCAA Director's response to Mr. Hale's request for a list of audit reports of direct labor distribution. The Director responded that, "We have no readily available means of identifying these reports." The Director suggested that we would have to review about 10,000 audit reports over the two-year period prior to Mr. Hale's request in order to get an answer to our question. The fact is, and was, that the DCAA has a "state of the world" report which identifies the types of audits we were requesting by code number. We later learned that Code No. 130 in the DCAA system refers to labor audits generally, and that Code No. 3A13004 refers to audits focused on labor distribution practices, also that Code 1A13004 identifies audits on labor charging practices.

My associates and I concluded from this response that the Director was attempting to mislead our Assistant Secretary on the information we needed to discharge our stewardship responsibilities. After we reported this to Mr. Hale, he wrote the enclosed May 25, 1983, memo to the Assistant Secretary of Defense (Comptroller) complaining about the lack of cooperation from DCAA. (Enclosure 7) Mr. Hale's comment that "DCAA's response ... to our request for assistance leads me to question whether or not 'we are playing on the same team'" is a widely shared sentiment.

So far as I know, Mr. Hale never received a substantive responsive to either of his requests for assistance.

ENCLOSURE 1

DS Barn
TK 15 Mar 82
Pad
P+W/WPB

This report was withdrawn!! by DCAA!!

AUDIT REPORT ON EVALUATION OF
PROPOSED 1982-1984 FORWARD
PRICING DIRECT LABOR RATES
UNITED TECHNOLOGIES CORPORATION
PRATT & WHITNEY AIRCRAFT GROUP
GOVERNMENT PRODUCTS DIVISION
WEST PALM BEACH, FLORIDA

The Defense Contract Audit Agency has no objection to the release of this report, at the discretion of the Contracting Officer, to the duly authorized representatives of Pratt & Whitney Aircraft Group, Government Products Division.

Under the provisions of Title 32, Code of Federal Regulations, Part 290.26(b) (2) (as amended August 10, 1977), all Freedom of Information Act requests for audit reports received by DCAA will be referred to the cognizant contracting officer for determination as to releasability and a direct response to the requestor.

Contractor information contained in this audit report may be confidential. The restrictions of 18 USC 1905 should be considered before this information is released to the public.

This report may not be released to any Federal agency outside the Department of Defense without the approval of Headquarters, DCAA, except to an agency requesting the report in negotiating or administering its contract.

DEFENSE CONTRACT AUDIT AGENCY
ATLANTA REGION
PRATT & WHITNEY AIRCRAFT RESIDENT OFFICE
P. O. BOX 2691
WEST PALM BEACH, FLORIDA 33402

RECEIVED
15 MAR 1982
AFPRO/TMQ WPB

Audit Report No. 1481-2A230006

Date of Report: 13 March 1982

DEFENSE CONTRACT AUDIT AGENCY
ATLANTA REGION
PRATT & WHITNEY AIRCRAFT RESIDENT OFFICE
P. O. BOX 2691
WEST PALM BEACH, FLORIDA 33402

REPLY REFER TO

1.481/MG

13 March 1982

SUBJECT: Report on Evaluation of Proposed 1982-1984
Forward Pricing Direct Labor Rates
United Technologies Corporation
Pratt & Whitney Aircraft Group
Government Products Division
West Palm Beach, Florida
Audit Report No. 1481-2A230006

Report has been With drawn

TO: Administrative Contracting Officer
AF Plant Representative Office (Det 4)
Pratt & Whitney Aircraft Group
Government Products Division
West Palm Beach, Florida
ATTN: TM (H. J. Moyes, PACO)

1. Purpose and Scope of Audit.

a. In accordance with the AFPRO (Det. 4)/TMO letter dated 29 January 1982, we reviewed the subject forward pricing labor rate proposal dated 27 January 1982 to provide an advisory audit report to assist in the negotiation of labor rates. The proposal provides for domestic forward pricing direct labor rates for 1982-1984.

b. The evaluation was performed in accordance with generally accepted auditing standards and included such tests of the contractor's data and records and such other auditing procedures as considered necessary in the circumstances except as noted in paragraph 2. The cost principles contained in DAR Section XV, Part 2, and the practices required by applicable Cost Accounting Standards were used as criteria in the evaluation of the proposed rates.

2. Summary of Audit Results.

a. The results of audit, summarized on Exhibit A of this report, show that GPD has proposed over $150 million of excess labor costs to be incurred on current and future contracts from 1981 thru 1984. Our recommended direct labor rates will, over the 1982-1983 time frame, bring these abnormal GPD labor related costs in line with national averages and inflation indices.

b. In our opinion, the offeror has submitted adequate cost or pricing data. The proposal was prepared in accordance with applicable Cost Accounting Standards and DAR Section XV, Part 2. Therefore, we consider the proposal to be acceptable for negotiation of a price. This statement should not be interpreted to mean that the data are necessarily accurate, complete and current in accordance with Public Law 87-653, since a postaward audit review may disclose evidence not now discernible. Nor should the statement be interpreted to mean that the offeror is necessarily in compliance in all respects with Public Law 91-379, since a final recommendation cannot be made in a preaward evaluation. Instances of additional noncompliance with Public Law 91-379 may be reported during contract performance.

c. Factual audit matters were discussed with the contractor's authorized representative, Mr. J. H. Hritz, Contracts Liaison, to the extent necessary to ensure that the conclusions reached by the auditor were based on a proper understanding of the data involved, but results of audit were not disclosed.

d. Accounting counsel or additional audit services, as may be required, will be provided upon request to this office (Attention: Mr. L. Rink, Supervisory Auditor, telephone 305/840-4064). In any case, additional audit support should be requested if changed requirements or more current cost or pricing data have a significant impact on the proposal. We recommend that an auditor be invited to attend negotiations.

e. As required by DAR 3-807.8(c), please furnish us a memorandum of the negotiations as promptly as possible. In addition, a copy of the forward pricing rate recommendation memorandum is requested.

f. This report should not be used for other than the purpose stated in paragraph 1 above without prior consultation with this office.

Defense Contract Audit Agency

George R Stanton
GEORGE R. STANTON, Resident Auditor

Encl. a/s
Copy furnished:
AFPRO/CC
RAMA-1 (Mr. A. Tueller)

Audit Report No. 1431-2A430006 S1

EXHIBIT A
Page 1 of 6

United Technologies Corporation
Pratt & Whitney Aircraft Group
Government Products Division
West Palm Beach, Florida

STATEMENT OF CONTRACTOR'S 27 JANUARY 1982 PROPOSED FORWARD PRICING DIRECT LABOR RATES AND RESULTS OF AUDIT REVIEW

	Contractor's Proposed Rates			Results of Audit Review (Note 1) Questioned Rates			
Labor Category	1982	1983	1984	1982	1983	1984	Notes
Engr. Salary Nonexempt	$10.08	$11.54	$13.09	$ .57	$1.79	$2.68	2
Engr. Salary Exempt	16.98	19.54	22.02	.97	3.13	4.49	2
Engr. Treasury	27.53	31.51	35.73	1.60	4.93	7.34	2
Manufacturing Hourly	10.73	11.75	12.77	.65	1.42	1.75	3
Test Hourly	12.11	13.13	14.15	.72	1.46	1.70	3
Test Salary Nonexempt	11.51	13.17	14.94	.69	2.08	3.11	3
Test Salary Exempt	17.08	19.54	22.16	.96	3.01	4.52	3
Quality Hourly	10.82	11.84	12.86	.66	1.43	1.75	3
Quality Salary Nonexempt	9.11	10.42	11.82	.08	1.16	1.94	3
Quality Salary Exempt	14.94	17.10	19.39	.85	2.65	3.97	3
Tooling Hourly	11.13	12.15	13.17	.75	1.51	1.82	3
Assembly Hourly	11.01	12.03	13.05	.62	1.38	1.69	3
Field Srvc. Salary Exempt	17.03	19.49	22.10	.46	2.03	3.45	4
Tech. Pubs Salary Nonexempt	8.02	9.18	10.41	.27	1.01	1.68	4
Tech. Pubs Salary Exempt	14.57	16.67	18.91	.41	1.75	2.98	4
AGE Design Salary Exempt	16.06	18.37	20.84	.51	1.98	3.34	4

Explanatory Notes:

1. Government contractors must be sensitive to labor costs in that they are spending Government funds. With regard to the expectation of judicious management by Defense contractor's in expenditures against Government programs, DAR 15-201.3(a)(iii) states that the responsibilities of a prudent business man to the Government and the public at large shall be considerations in determining the reasonableness of a given cost. As discussed below, GPD's actual and proposed direct labor rates are higher than they should be to retain employees and remain competitive in the private sector. Therefore, our recommended rates are based on criteria which consider both Federal and private sector escalation during the years 1982-1984.

The chart on Appendix 1 illustrates the year to year GPD engineering labor rate escalation compared with Federal employee and private industry escalation. The basic cause of this labor cost escalation is the salary increases GPD gives to its employees, as indicated by the following comments and statistics:

As parts of our review of direct labor rate escalation we obtained a special labor rate (computer) listing from GPD covering only those employees on board both in December 1980 and in December 1981 (i.e., excluding new hires, terminations, etc.). Analysis of these listings disclosed average pay increases for employees on board from December 1980 through December 1981 of 15.8 percent for engineering direct labor, 25.3 percent for hourly manufacturing direct labor, 23.4 percent for hourly test direct labor, and 14.8 and 14.9 percent for manufacturing and test salary direct labor, respectively. The average labor rate for all engineering department employees of $13.09 per hour for December 1980 compared to $15.31 per hour for December 1981 represents an increase of 17.0 percent. This additional 1.2 percent average increase over the 15.8 percent increase noted previously is attributed to changes in skill mix, turnover, reduction in salary nonexempt employees, transfers, etc.

In support of our opinion that actual engineering pay increases of 15.8 percent from 1980 to 1981 are larger than necessary for staff rententions, our review disclosed the following:

(1) Actual pay increases in engineering departments, as measured from December 1980 to December 1981, ranged up to a high of 37 percent and averaged 15.8 percent:

Distribution of Engineering Department Pay Raises in 1981

Pay Raise	Number of Employees*				
Percentage	Nonexempt	Exempt	Treasury	Total	Distribution
(0.05)	--	--	1	1	0.1%
0	1	1	--	2	0.1%
5	--	1	--	1	0.1%
6	5	8	1	14	0.7%
7	5	18	2	25	1.3%
8	1	10	--	11	0.6%
9	0	1	1	2	0.1%
10	1	5	1	7	0.3%
11	14	40	7	61	3.2%
12	46	158	29.	233	12.3%
13	66	210	33	309	16.3%
14	58	154	25	237	12.5%
15	40	102	23	165	8.7%
16	21	81	12	114	6.0%
17	22	86	6	114	6.0%
18	20	67	4	91	4.8%
19	7	62	4	73	3.9%
20	10	68	6	84	4.4%
21	9	57	4	70	3.7%
22	7	44	2	53	2.8%
23	8	35	2	45	2.4%
24	11	32	--	43	2.3%
25	9	25	--	34	1.8%
26	6	19	--	25	1.3%
27	3	18	--	21	1.1%
28	4	13	--	17	0.9%
29	2	9	--	11	0.6%
30	1	9	--	10	0.5%
31	1	6	--	7	0.3%
32	2	3	1	6	0.3%
33	1	1	--	2	0.1%
34	1	2	--	3	0.2%
35	1	--	--	1	0.1%
36	1	1	--	2	0.1%
37	1	--	--	1	0.1%
	385	1346	164	1895	100%

*Covers only engineering employees on board during all of 1981 (i.e., excludes new hires, terminations, transfers in and out).

(2) Direct engineering labor decreased in 1981 (from 1980) by approximately 360,000 hours, primarily in the area of nonexempt salary labor.

(3) Since the engineering workforce was in a declining mode in 1981, most promotions would be the result of replacement/restructuring of the existing workforce. Our review disclosed no major changes in the mission of the engineering department.

(4) Promotions are not considered a primary contribution to the escalation in pay rates since the largest reduction in engineering was in the salary nonexempt category. Such a reduction would create a requirement for less supervision as opposed to more supervision. Contractor personnel have indicated that the reductions were the result of declining business levels and not as a result of increased productivity.

(5) We found no evidence of staff recruitment or retention problems that required such a substantial 1981 increase.

The chart on Appendix 3 (see related notes) compares the GPD average increase for those employees on board at both December 1980 and December 1981 with labor escalation in private industry and the rise in the consumer price index. As this chart indicates, GPD granted raises which were 178 percent higher than Federal employee escalation and 108 percent higher than all private industry (nonsupervisory, nonagricultural) workers. The chart on Appendix 4 details these increases by principal GPD direct labor categories. The impact of the 1981 rate increase (see Appendix 2 chart) compounds through 1984 as estimated annual escalation rates are applied to that base. The chart on Appendix 5 graphically portrays the potential labor cost (direct and indirect) impact (about $155 million) of GPD rate increases that exceed our estimate of reasonable escalation for the years 1981 through 1984. This difference is generated by our use of national averages and inflation indices in our evaluation of proposed labor rates. GPD's 1981 increases cannot be changed. However, its planned escalation can be brought into line with the three year estimated average of Federal employee and private industry escalation for 1981-1983. Our recommended (reduced) escalation in 1982 and 1983 will only bring GPD's labor rates into line with our estimate of reasonable escalation for that period. Our adjustment will not allow recovery of all the additional costs incurred on Government contracts because of the actual 1981 increase (see Appendix 6 chart).

The 1982 salary escalation of 10.5 percent proposed by GPD effective June 1982 is based on an average of the escalation rates of 10.9 percent for engineers and 10.0 percent for accountants [which were taken from the National Survey of Professional, Administrative, Technical, and Clerical Pay, and represent percentage increases from average March 1980 salaries to average March 1981 salaries]. The 1983 and 1984 proposed escalations are based on undocumented judgmental estimates (by Messrs. J. C. Macko, Contracts Liaison, and L. M. Mazer, Business Forecasting) of five percent annually for general wage increases and skill mix enrichment, and an additional eight percent for merit increases. We find these rates unacceptable because (i) no consideration is given to current economic forecasts which show substantial reductions in inflation for 1982 thru 1984 compared to the March 1980-March 1981 base period used by GPD, (ii) no consideration is given to (offsetting) the sizable individual raises granted by GPD during 1981, (iii) provision is made for skill mix enrichment which is not justified by increased (higher skill) requirements, (iv) no consideration is given to public policy concerns to reduce spending on Government programs/contracts, and (v) the annual increases (of five percent for general wage increases and skill mix enrichment) and the additional eight percent for merit increases represent unsupported/judgmental estimates.

We recommend that the proposed 1982 and 1983 rate increases be limited sufficiently to adjust for GPD's 1981 increase. A reasonable rate of escalation for the 1981 thru 1983 period will be attained by limiting proposed escalation for 1982 and 1983 to rates which, when compounded with the actual 1981 increase will approximate the cumulative 1981-1983 average of private industry and Federal employee escalation. In 1984, GPD should have its labor rates in line and 1984 recommendations could be based on the recommended 1983 direct labor rate, escalated by the expected 1984 private industry/Federal employee average percentage increase. Computations are shown in Notes 2 thru 4.

2. Our recommended engineering labor rates are based on the rationale described in Note 1. The recommended rates for 1982 and 1983 were calculated by escalating 1981 actual labor rates by our recommended escalation factors computed as follows:

			Estimated			
Engineering		Actuals 1980 - 1981(a)	1981 - 1982(a)	1982 - 1983(a)	Three Year Compounded Escalation	1983 - 1984(a)
Government Labor Escalation	(b)	8.0%	5.4%	6.6%		5.5%
Private Industry Escalation	(c)	10.0%	8.0%	8.0%		8.0%
Average Escalation	(d)	9.0%	6.7%	7.3%	24.8%	6.8%
Recommended Escalation Factor	(e)	18.8%	2.5%	2.5%	24.8%	6.8%
Recommended Yearly Average Labor Rates	(f)	1981	1982	1983		1984
Salary Nonexempt		$ 9.28	$ 9.51	$ 9.75		$10.41
Salary Exempt		$15.62	$16.01	$16.41		$17.53
Treasury		$25.30	$25.93	$26.58		$28.39

(a) The percentages shown represent the (rate of) escalation from the 12 month average labor rate of one year to the 12 month average labor rate of the following year.

(b) Represents the average escalation of all Federal employees in labor grades GS-7 thru GS-13 from year to year, based on increases of 4.8 percent, 7 percent, 5.5 percent and 5.5 percent for the 12 month periods beginning in October of 1981 thru 1984, respectively, including the impact of turnover, step increases which average 1 1/2 percent annually, and within grade changes in mix.

(c) The estimated private industry escalation rates for the years 1980 thru 1984 were based on the 1976 thru 1981 average March year to year relationship of nationwide engineering increases with rises in the consumer price index (CPI) and the Bureau of Labor Statistics index for private industry manufacturing hourly earnings, as shown below. Nationwide engineering increases are from Text Table 2 of the Bureau of Labor Statistics National Survey of Professional, Administrative, Technical, and Clerical Pay (PAT&C) which measures average March year to year percentage salary increases by using January thru April data collections to reflect an average March reference period.

		Index of Avg. Hourly Earnings —Mfg.	Nat'l. Survey of PAT&C		
Actuals (1)	CPI		Engineering	Engineering Technician	Weighted Average(2)
March 1976-March 1977	6.1%	9.4%	6.4%	7.2%	6.6%
March 1977-March 1978	6.5%	8.9%	9.0%	7.1%	8.5%
March 1978-March 1979	10.0%	9.0%	8.4%	7.6%	8.1%
March 1979-March 1980	14.4%	7.5%	9.8%	11.0%	10.2%
March 1980-March 1981	10.9%	10.8%	10.9%	10.2%	10.7%
Projections (3)					
1980-1981	10.3%(4)	9.2%(4)			10.0% (5)
1981-1982	7.4%(4)	7.3%(4)			8.0% (5)
1982-1983	7.5%(4)	7.6%(4)			8.0% (5)
1983-1984	7.2%(4)	7.9%(4)			8.0% (5)

(1) Actuals represent year to year average March percentage increases (i.e., the average of the first four months of one calendar year compared to the same average one year later, expressed as a percentage change) for comparability with the National Survey of PAT&C (Text Table 2) data.

(2) The weighted average actuals represent a composite of the percentage increases in Engineering and Engineering Technician salaries shown in Text Table 2 of the March 1981 National Survey of PAT&C. The composite (average) was weighted based on the ratio of GPD salary nonexempt (engineering technician) labor to GPD salary exempt and treasury (engineering) labor, as follows:

Period	Engineering	Engineering Technician
March 1976-March 1977	76%	24%
March 1977-March 1978	74%	26%
March 1978-March 1979	68%	32%
March 1979-March 1980	68%	32%
March 1980-March 1981	74%	26%

(3) The projections differ from the actuals in that the projections are based on the percentage increase of the 12 month average (midpoint) of one year over the 12 month average (midpoint) of the following year.

(4) The CPI and Private Industry Manufacturing Average Hourly Earnings projections represent Data Resources, Inc. predictions as of February 1982.

(5) The weighted average (composite) engineering projections are auditor estimates based on the historical percentage increase relationships of the composite engineering rate to the CPI and Manufacturing Average Hourly Earnings indices and the DRI projections of these indices, rounded to whole percents.

(d) Represents the arithmetic mean of private industry escalation [see Note 2(c)]. and Federal employee escalation [see Note 2(b)].

(e) The 18.8 percent GPD increase in 1981 is the actual incurred percentage increase of the composite GPD Engineering Department average direct labor rates from $12.63 in 1980 to $15.01 in 1981. The 6.8 percent escalation recommended for 1983-1984 is the projected average of private industry escalation and Federal employee escalation [see Note 2(d)]. The recommended 2.5 percent GPD escalation factors for 1982 and 1983 represent those factors which, when compounded with the 18.8 percent actual 1981 incurred increase, will equate to the 24.8 percent compounded three year total average of private industry escalation and Federal employee escalation for the period 1981-1983 [see Note 2(d)].

(f) The recommended direct labor rates represent the GPD actual 1981 incurred average rates, escalated by the recommended factors of 2.5 percent for 1982, 2.5 percent for 1983 and 6.8 percent for 1984 [see Note 2(e)]. The questioned rates shown in Exhibit A are the difference between the 27 January 1982 proposed rates and our recommended direct labor rates.

3. The questioned manufacturing, test, quality, tooling and assembly rates are based on the same rationale described in Notes 1 and 2. Computation of the recommended GPD labor rates follows:

	Actual	Estimated			
Operations	1980-1981	1981-1982	1982-1983	Three Year Compounded Escalation	1983-1984
Government Labor Escalation	8.0%	5.4%	6.6%		5.5%
Private Industry Escalation-Mfg. (a)	9.2%	7.3%	7.6%		7.9%
Average Escalation	8.6%	6.4%	7.1%	23.8%	6.7%
Recommended Escalation Factor	17.9% (b)	2.5%	2.5%	23.8%	6.7%
Recommended Yearly Average Labor Rates	1981	1982	1983		1984
Mfg. Hourly	$ 9.83	$10.08	$10.33		$11.02
Test Hourly	$11.11	$11.39	$11.67		12.45
Test Salary Nonexempt	$10.56	$10.82	$11.09		11.83
Test Salary Exempt	$15.73	$16.12	$16.53		17.64
Quality Hourly	$ 9.91	$10.16	$10.41		11.11
Quality Salary Nonexempt	$ 8.81	$ 9.03	$ 9.26		9.88
Quality Salary Exempt	$13.75	$14.09	$14.45		15.42
Tooling Hourly	$10.13	$10.38	$10.64		11.35
Assembly Hourly	$10.14	$10.39	$10.65		11.36

(a) Private Industry Average Hourly Earnings—Manufacturing represent Data Resources, Inc. actual/predictions as of February 1982.

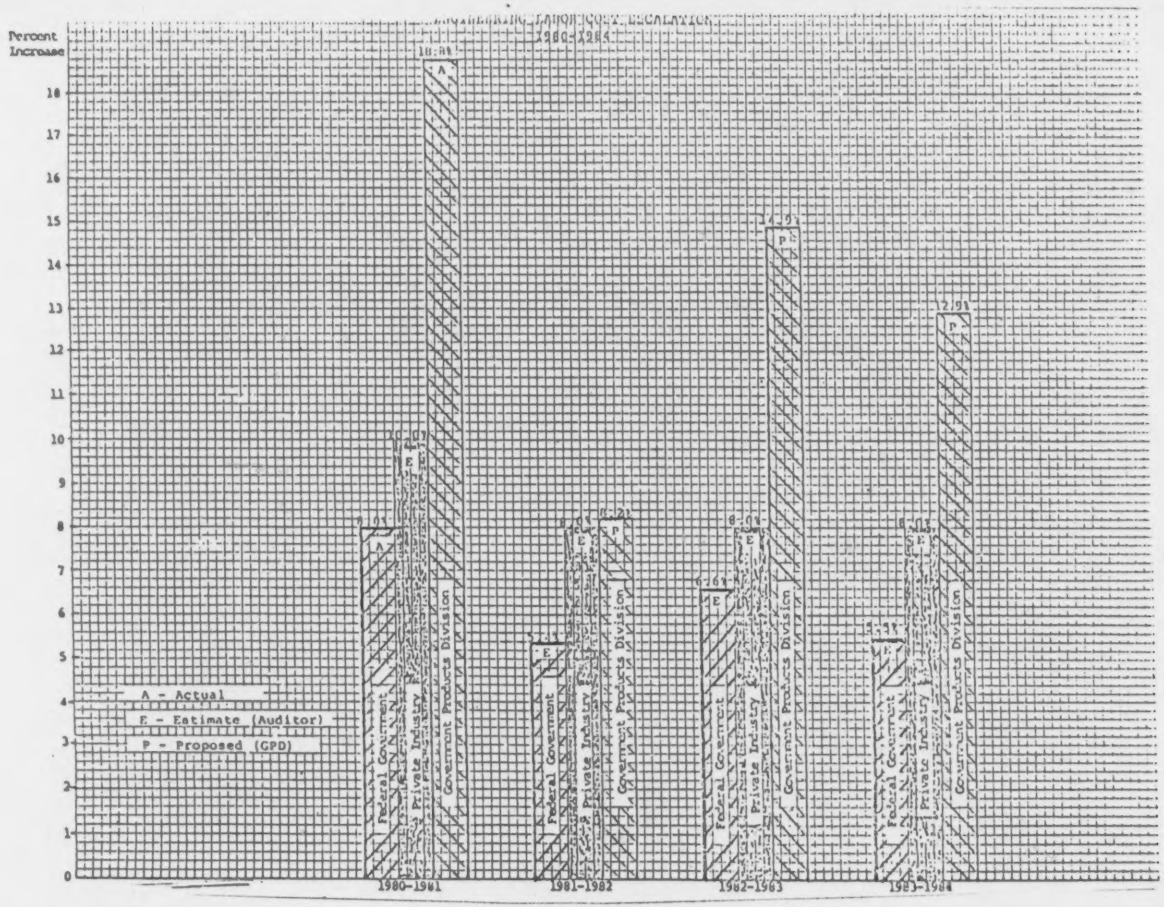
(b) The actual 1981 direct labor hour mix of operations rate categories was used to compute the 17.9 percent composite rate escalation from 1980 to 1981.

4. Questioned product support labor rates are also based on the same rationale stated in Notes 1 and 2:

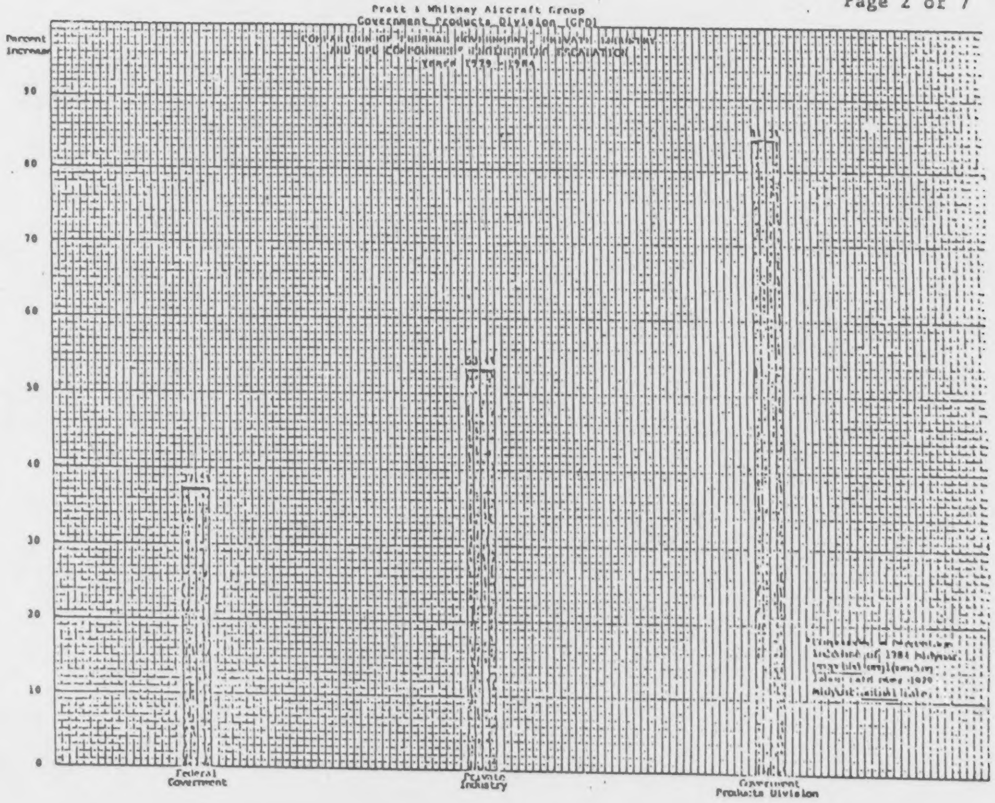
	Actual	Estimated			
Product Support	1980-1981	1981-1982	1982-1983	Three Year Compounded Escalation	1983-1984
Government Labor Escalation	8.0%	5.4%	6.6%		5.5%
Private Industry Escalation (a)	10.0%	8.0%	8.0%		8.0%
Average Escalation	9.0%	6.7%	7.3%	24.8%	6.8%
Recommended Escalation Factors	12.4% (b)	5.4%	5.4%	24.8%	6.8%
Recommended Yearly Average Labor Rates	1981	1982	1983		1984
Domestic Field Service	$15.72	$16.57	$17.46		$18.65
Tech. Pubs. Nonexempt	$ 7.35	$ 7.75	$ 8.17		$ 8.73
Tech. Pubs. Salary Exempt	$13.43	$14.16	$14.92		$15.93
AGE Design Salary Exempt	$14.75	$15.55	$16.39		$17.50

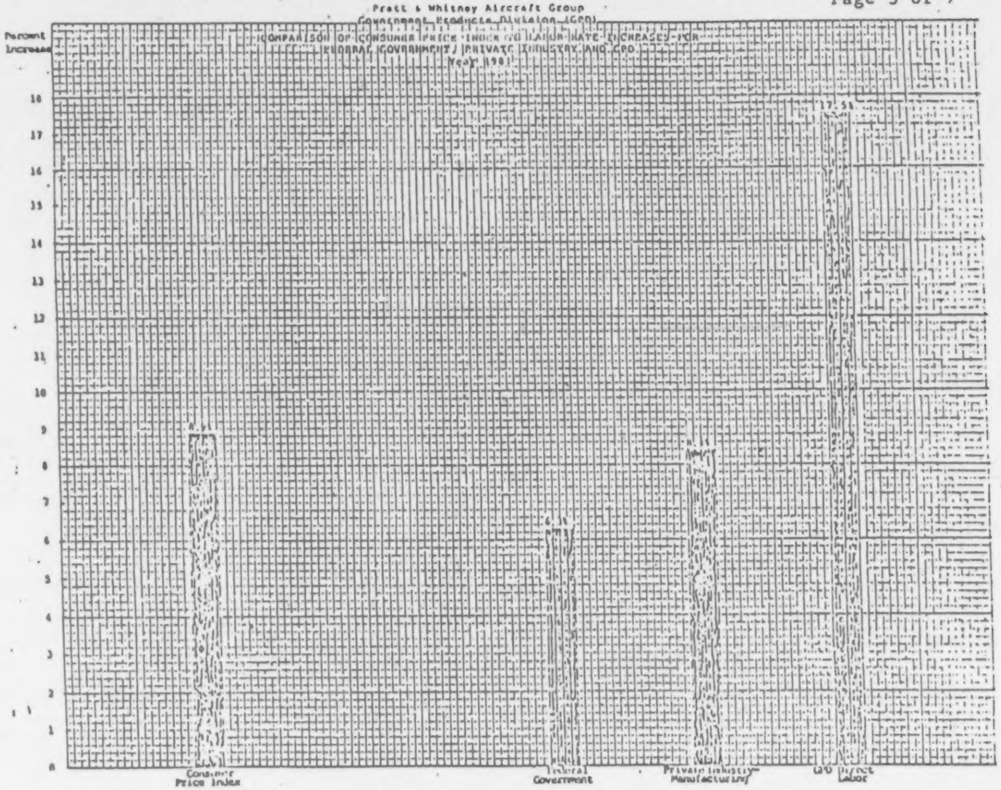
(a) See Note 2(c) above.

(b) The actual 1981 direct labor headcount mix of the product support rate categories was used to compute the 12.4 percent composite rate escalation from 1980 to 1981.


ENGINEERING LABOR COST ESCALATION
1980-1984
Percent Increase
0
1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
18.8%
10.0%
8.0%
8.2%
14.9%
12.9%
A
E
P
Federal Government
Private Industry
Government Products Division
1980-1981
1981-1982
1982-1983
1983-1984
A - Actual
E - Estimate (Auditor)
P - Proposed (GPD)

Appendix 2
Page 2 of 7



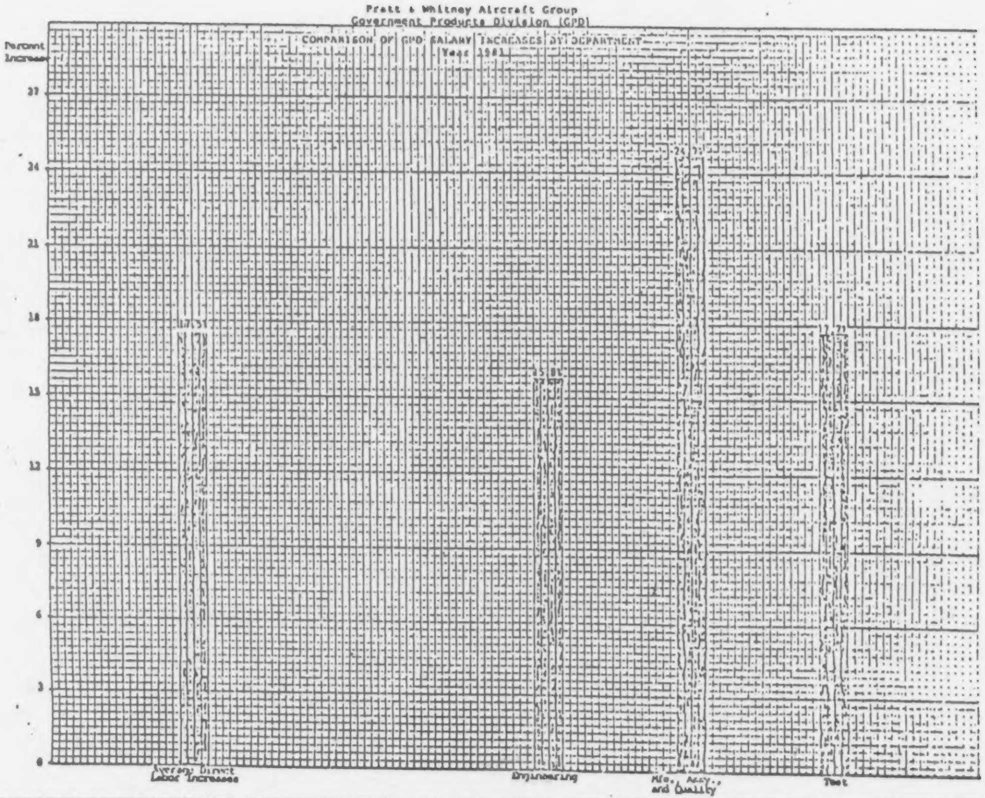


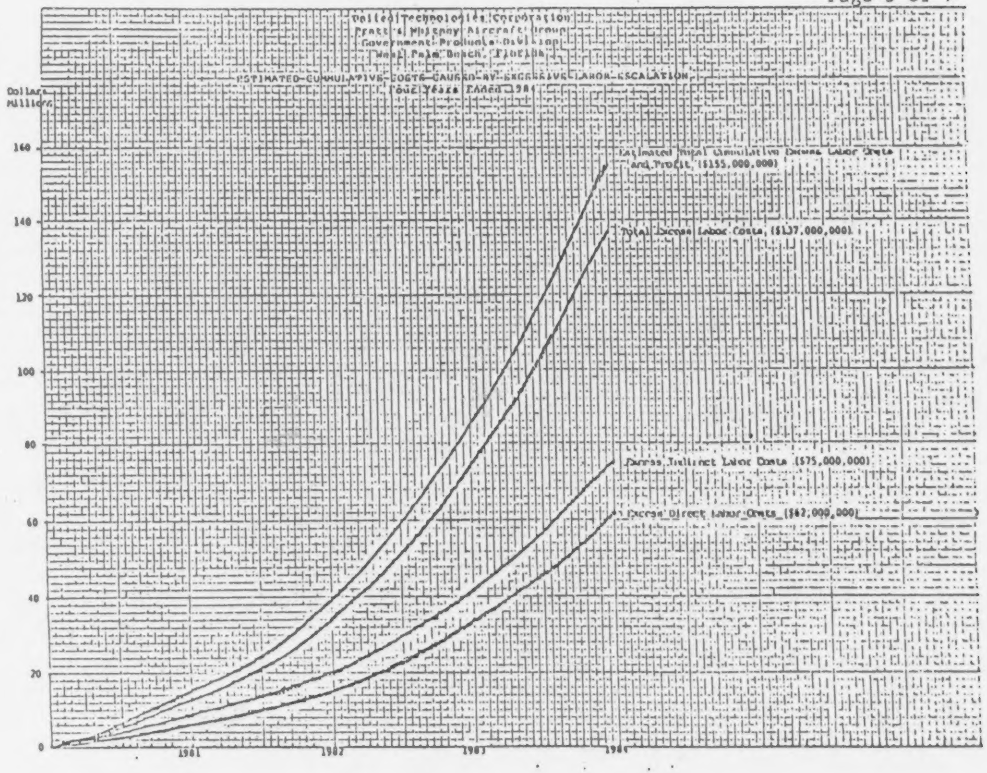
Pratt & Whitney Aircraft Group
Government Products Division (GPD)
COMPARISON OF CONSUMER PRICE INDEX TO LABOR RATE INCREASES FOR
FEDERAL GOVERNMENT, PRIVATE INDUSTRY AND GPD
Year 1981

Appendix 4
Page 4 of 7

Pratt & Whitney Aircraft Group
Government Products Division (GPD)

COMPARISON OF GPD SALARY INCREASES BY DEPARTMENT
Year 1981




United Technologies Corporation
Pratt & Whitney Aircraft Group
Government Products Division
West Palm Beach, Florida
ESTIMATED CUMMULATIVE COSTS CAUSED BY EXCESSIVE LABOR ESCALATION
Four Years Ended 1984
Dollars Millions
160
140
120
100
80
60
40
20
0
1981
1982
1983
1984
Estimated Total Cumulative Excess Labor Costs and Profit ($155,000,000)
Total Excess Labor Costs ($137,000,000)
Excess Indirect Labor Costs ($75,000,000)
Excess Direct Labor Costs ($62,000,000)

Explanatory Notes to Charts on Appendixes 1 thru 5:

1. The chart on Appendix 1 compares year to year GPD actual and proposed composite engineering labor escalation with private industry and Federal Government escalation. The escalation rates shown on the Appendix 1 chart are the percentage increases, from calendar year midpoint to the next calendar year midpoint, of average direct engineering labor. The comparison shows that a given amount of engineering labor performed by GPD in 1981 cost 18.8 percent more than it would have cost in 1980.

2. The chart on Appendix 2 illustrates the total effect of the same data on a compounded basis from 1979 to 1984 rather than year by year.

3. The Appendix 3 chart shows GPD average December 1980 to December 1981 percentage salary increases for employees who remained on board the entire year compared with the increases in the Consumer Price Index and the Index of Average Manufacturing Hourly Earnings during the same period.

4. The Appendix 4 chart breaks out the GPD direct labor increases by major operating area (function). The differences between the individual percentage increases shown on the Appendix 4 chart and the 1980-1981 actual escalation factors shown in Notes 2 and 3 of Exhibit A and also shown on the Appendix 1 chart, are due to timing and skill mix differences. For example, the 15.8 percent engineering increase for 1981 shown on the Appendix 4 chart represents the average percentage increase in pay rates for engineers on board at 31 December 1980 and 1981 based on actual annual salary levels per employee at 31 December. The 18.8 percent increase shown in Note 2 to Exhibit A and on the Appendix 1 chart represents the overall increase in the total average engineering labor rate between 1980 and 1981, includes the effect of terminations and skill mix enrichment, and is based on total salaries paid and hours worked for each of the two years.

5. The cost lines on the Appendix 5 chart were computed as follows:

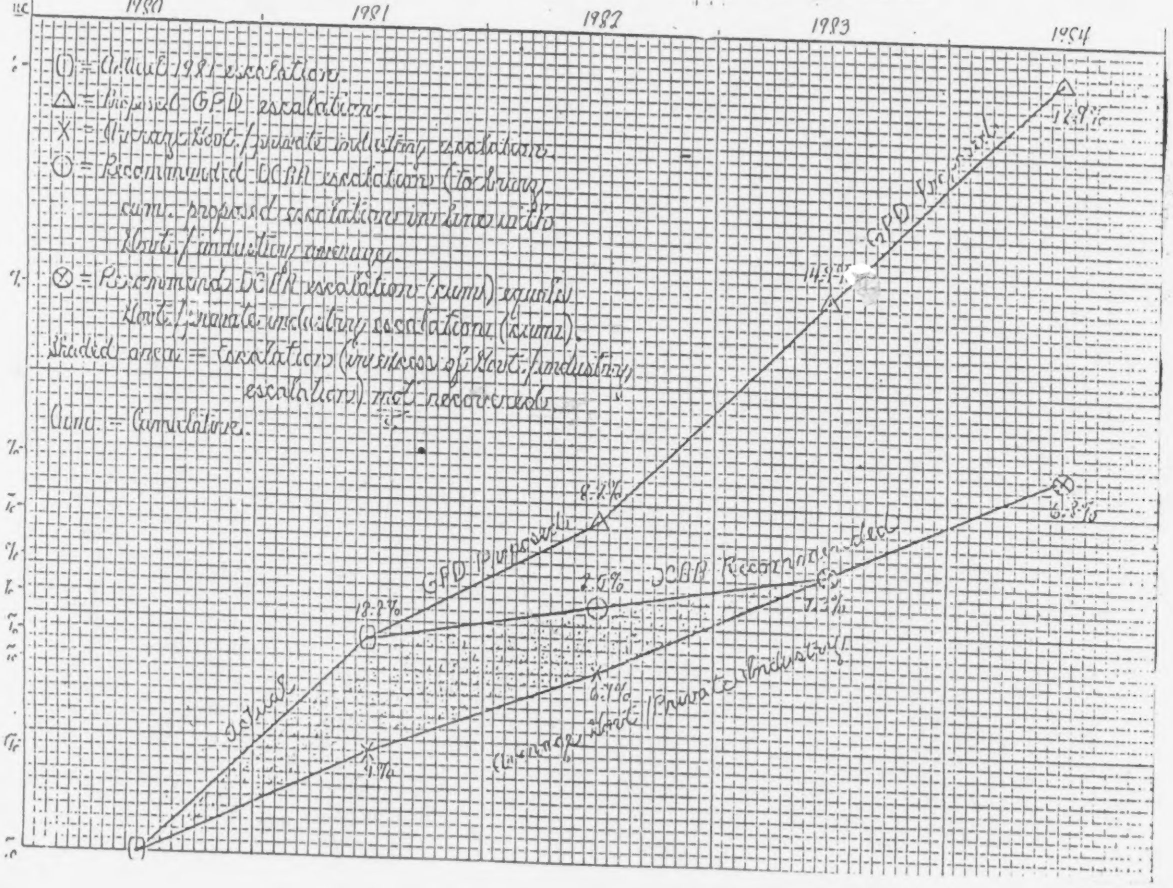
a. The 1981 level of effort (actual hours) were used (held constant thru 1984) to calculate the excess labor costs for 1981 thru 1984. The point on the direct labor cost line for 1981 is the difference between the actual costs for 1981 and what the costs would have been had the labor (including fringe benefits) risen only by the average private industry/Federal employee rate of escalation as detailed in Notes 2, 3 and 4 to Exhibit A. The 1982, 1983 and 1984 cumulative amounts are based on the sum of (i) 1981 actual labor hours times the difference between the proposed labor rates and the "expected" rates plus (ii) applicable fringe, diverted direct labor, and prior year labor (since 1980). The "expected" labor rates represent 1980 actuals, escalated by an average of Government and private industry escalation.

b. Indirect labor escalation impact was estimated by advancing (marking up) the direct labor cost line by the ratio of indirect payroll dollars to direct payroll dollars (55% divided by 45% or 1.22222). This estimate was based on the assumption that indirect labor escalation approximates that of direct labor. (GPD does not accumulate the type of indirect labor rate data that it does for direct, which precludes estimating more accurate indirect labor escalation.)

c. The total labor cost line is a combination of the direct and indirect cost lines.

d. The total cost to the Government is the total labor cost line plus a profit rate of 13.4 percent.

PROPOSED AND RECOMMENDED YEARLY AVERAGE/CUMULATIVE ENGINEERING ESCALATION



[illegible]
[illegible]

OFFICE OF THE SECRETARY

ENCLOSURE 2

April 15, 1982

MEMORANDUM FOR MR. HALE, SAF/FM

When the President's Budget is submitted to Congress there is a 5% cost-of-living raise for civilian personnel and 8% for military.

Under current budget discussions, there is much conversation about reducing one or the other, or both, of these percentage amounts. In addition, there is a great deal of discussion about placing some sort of a lid on cost-of-living increases in various entitlement programs such as social security and military retirement.

As we approach our weapon systems, we often encounter contracts which provide for us to pay increased costs due to wage settlements which the contractor made with his labor force.

I think it is absolutely ludicrous to expect all elements of government and all retirees and pensioners from government to undergo strict limitation of their receipts from our Federal Government while at the same time, through our contracts, we pay substantially larger increases to labor forces building our weapon systems.

Please make every effort to see that we do not pay negotiated wage settlements to our weapon producers which are greater than the amounts which the Federal Government decides are adequate for its own employees and recipients.

This may involve insisting that some contractors take the excess negotiated payments out of their profits. It could even involve a case where there are work stoppages.

I am fully prepared to accept work stoppages in some of our weapon acquisition programs, if that is what it takes to bring inflation under control and to bring wage settlements down to the level which the Federal Government deems adequate for its own people.

Will you see that this policy is distributed widely to the civilian and military members who negotiate with our contractors. It should be made available to the contractors before they complete labor negotiations and not after.

Verne

Verne Orr

ENCLOSURE 3

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

13 JUL 1982

MEMORANDUM FOR MR. FITZGERALD, SAF/FMM

SUBJECT: Labor Rates in Production of Aerospace Weapons Systems

Labor cost is the product of two basic elements, hours and rates of pay. Government contractors on a cost plus basis, or on a negotiated fixed price basis determined by their costs of doing business, have no incentive to hold down labor hours nor labor rates on their governmental work. As a practical matter, if the entire effort of a plant is production for government and there is no credible, ongoing threat of the Government taking its business elsewhere, the only incentive for the contractor is to allow labor costs to increase, which will facilitate absorption of increased overhead costs and increased general and administrative costs, augmenting gross revenues across the board, and permitting increased net profits. Similarly, where plants have mixed governmental and private sector production, the contractor's fundamental self-interest is to allow (or to facilitate) increases in the proportion of total labor hours charged to government contracts, which causes a proportional shift of indirect labor costs, all other overhead costs, and general and administrative costs onto the government contracts and away from commercial production costs. A recent study by the Directorate of Management Analysis (AF/ACM) shows that by May 1982 aerospace labor rates reached a level 44% above other manufacturing and 39% above durable goods in the Bureau of Labor Statistics (BLS) categories (see Attachment 1). That gross disparity has been increasing over time not merely in absolute terms, but also proportionally. This is clearly shown by the facts that ten years ago aerospace labor rates were 27% above other manufacturing and 22% above durable goods. The proportional trend is particularly ominous, and the situation will continue to get worse unless positive action is undertaken to reverse the process. [As an aside, it is perhaps significant that the only other U.S. production industry with equally anomalous labor rate costs is the U.S. Auto Industry, a fact which may augur ill for the U.S. aerospace industry, or more likely for the U.S. taxpaying public in general.]

A major contributing factor in the highly adverse trend of aerospace labor rate costs has been, and continues to be, the practice of doing compensation reviews not by looking at prevailing rates for the geographic area where the contractor is located, but by looking at "comparable" government contractors. To illustrate, the labor rates of a contractor in a low cost semi-rural area of Arkansas could be deemed justified if they were approximately the same as another contractor in the very high cost area of New York or Los Angeles, and without regard to the prevailing rates for similar or like work in the same Arkansas area. The segregation of aerospace contractors into a universe of their own facilitates the escalation of the industry labor rate essentially in lockstep at a pace that bears no relationship to economic constraints in general, and no relationship to comparable labor costs in other industries on either a national or geographic area basis. This basis for reviews or compensation (labor rates) is in complete contradiction to the Administration's policy on labor rates which forms the basis of the imminent changes in application of the Davis Bacon Act, which requires the payment of prevailing wages to workers on federally funded construction contracts. Specific changes in the rules now pending application by the Department of Labor are as follows:

1. "Prevailing wage" will be defined as the rate paid to at least a "majority" of workers in the area performing similar work. If there is no single rate paid to a majority of the workers, the "average" rate paid to all such workers will apply.

2. A strict prohibition against the use of wage survey data obtained from a metropolitan area in issuing a wage determination for a rural area, and vice versa.

The Administration's philosophy concerning labor rates (as above) should be employed in compensation reviews of defense contractors across the board (not merely in construction). This would be a useful first step in gaining control over the near run-away escalation of labor rates in the aerospace industry. This move would also conform to the philosophy clearly stated in Secretary Orr's memorandum of 15 April 1982 for Assistant Secretary Hale (Attachment 2).

During the team's visit to AFCMD, Kirtland Air Force Base, as a result of discussions concerning labor rates, we were provided with a copy of a DCAA audit dated 13 March 1982 made at the Pratt & Whitney Plant, West Palm Beach, Fla (Attachment 3). Someone at AFCMD had written "withdrawn by DCAA" on the audit. By telephone call to the DCAA auditor we subsequently learned that the report had not been officially withdrawn, but a version dated 14 April 1982 containing "softened" language had been substituted for it. When I inquired as to why it had been deemed necessary to make any change at all in the audit report as originally written, the auditor said his supervisors thought the language "too tough." He also observed that his supervisors, up to HQ DCAA level took the position that they "don't want to upset the procurement community." I asked specifically about that expression and he said the words reached him from higher levels in DCAA. By fortuitious coincidence, the original audit report findings and recommendations seem to be completely in accord with the intent of Secretary Orr's memorandum of

15 April referenced above.

The DAR, and agency/component supplements to the DAR, should be changed to clearly require application of the Administration's Davis Bacon labor rate policy across the board in Defense Acquisition. The labor rate negotiation policy contained in Secretary Orr's 15 April 1982 memorandum should be implemented forthwith by the procurement function.

COLIN D. PARFITT
Asst for Accounting & Audit
SAF/FMB

Attachments

CARIN

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

16 August 1982

MEMORANDUM FOR MR. HALE
MR. MITCHELL

This is a follow-up to Colin Parfitt's 13 July 1982 memo to me, Subject: Labor Rates in Production of Aerospace Weapons Systems, which I included as an attachment to my 15 July memo on Cost/Schedule Control Systems Criteria (C/SCSC).

Colin's report dealt primarily with George Spanton's report on labor rates at Pratt & Whitney Government Products Division (P&W GPD) in West Palm Beach, Florida. Subsequently, I have received two additional reports from Colin on this situation which I am forwarding to you under cover of this memorandum.

The first is a 9 August 1982 Memorandum for Record reporting on the trip which Colin and Jim Ririe made to West Palm Beach to visit with the AFPRO. I call your attention especially to two points in Colin's memo. First is the discussion of the applicable portion of the Defense Acquisition Regulation, DAR 15-205.6(a)(2). Colin recounts on page 4 of his memo that a copy of this portion of the DAR was given to him with the following requirement underlined:

> "(2) (CWAS) Compensation is reasonable to the extent that the total amount paid or accrued is commensurate with compensation paid under the contractor's established policy ..."

As Colin points out, the rest of the sentence reads:

> "... and conforms generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area, for similar services." (Underlining added).

Please note that the emphasis on local comparability which was recommended in Colin's 13 July memo is permitted under the existing DAR. Even though we have since been told by the General Counsel that the DAR will be changed to make it less ambiguous, it seems to me there is nothing to prohibit our going forward pending the DAR clarification.

The second point I wish to highlight in Colin's 9 Aug report is the extent of union influence. On page 5 of his report, Colin notes that only 15.7% of the total number of employees at P&W GPD belong to unions.

Since we have already dealt with the notion that the projected increases might be "catch-up" and with the fact that the "should cost" approach is already official policy, I believe that all excuses for holding off action on contractor wages and salaries on negotiated contracts are now removed.

Mr. Parfitt's second report, 12 Aug 82, deals with discrepant explanations for the rotation of the DCAA Audit Chief at P&W. I realize that you asked us not to conduct a "crusade" on behalf of the resident auditor, Mr. George Spanton, and we have not done so. From subsequent contacts with Mr. Spanton, I have come to believe that he is quite capable of conducting his own "crusade" if that be needed. However, some facts related to the excuses for transferring Mr. Spanton came to my attention which, in my opinion, had to be checked out. Both John Boddie and General Driessnack received the explanation that Mr. Spanton had been in his position for more than the five years provided for in DCAA's rules concerning mobility. As documented in Tabs 2 and 3 to Colin's 12 Aug memo, there is docmentary evidence that Mr. Spanton's allotted five years expire on 18 March 1983 -- not 15 September 1982.

If we have been deceived by DCAA Hq as the present evidence suggests, I think we must escalate this matter. If it should turn out that there is a "gentleman's agreement" to get Spanton out of the way, I don't think we can become a part of that process through inaction now that we have the information contained in Colin's 12 Aug memo.

Attachment

A. E. FITZGERALD
Management Systems Deputy

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

9 August 1982

MEMO FOR RECORD - TRIP REPORT - Visit to Pratt & Whitney
Government Products Division (P&W GPD)
West Palm Beach, FL - 27-28 July 1982

SAF/FM representatives were Mr. James Ririe and the undersigned.

Personnel contacted during the visit were:

Col John Roberts	Comdr, AFPRO
Mr. Hugh J. Moyes (Jay)	AFPRO/TM
Mr. Tony Sheppard	" /TMO
Mr. Paul Biadasz (Pricing)	" /TMF
Mr. Charles Haas	" /TMF

Colonel Roberts participated in the opening discussions for about the first hour of our visit. We explained in general terms the concerns of Secretary Orr regarding (1) the ususally late disclosures at his level of impending or imminent cost over-runs, and (2) the anomalously high rates of pay in the aerospace industry (which are, in all likelihood, only too typical of defense industries in general). We also explained the events to date in the review of C/SCSC by our office, concluding with the point that we were now moving to the second facet, labor rates, of the labor cost element of defense production.

After the general discussion, all personnel except Col Roberts adjourned to a conference room for detailed discussions of specifics.

With regard to the skill mix of P&W GPD's hands-on production workers, the AFPRO personnel had no information available. Similarly, they had no detailed information with respect to what kinds of engineers, or what specialty classifications of engineers, were working on various lines of endeavor. As of 9 July 1982, some 3266 of 6912 employees were classified as "direct labor" in the P&W GPD plant. Of the "direct" workers, only 650 were "hands on" type workers, such as machine operators, journeyman machinists, tool makers, etc. The remaining 2616 "direct" workers were presumably mostly engineers of various kinds (see Atch 1). The AFPRO people explained that

"Treasury" employees are people at the "Vice President" level whose individual compensation is not generally known and who are paid from a higher level in the parent company, United Technologies Corporation. I asked about "Compensation Reviews". None had been done since the Air Force took cognizance from the Navy in 1977, and no one knew if any had been done during the Navy's incumbency at the plant. As a result of the recent (March 13/April 14) DCAA audit report, the DCAS had been requested to do a compensation review, and by fortunate coincidence, two copies of the completed review were provided to the AFPRO during our visit. Jim Ririe has xerox copies of large segments of this DCAS report.

In response to our request for employee data in the same breakout as that of the 13 March 1982 DCAA report on wage rates, we were provided the handwritten data in Attachment 2 that showed 3248 "direct" and 3714 "indirect" workers as of 30 June 1982. Much later in the day, we returned to the subject of "who was working on what?" Mr. Moyes said that the AFPRO organization will do an initial review of a sample of the higher-graded engineers to find out what skills are devoted to what lines of endeavor, and will examine the feasibility of doing a full-scale review. They expect to undertake this effort within two months. If a full study is undertaken, it will be done in FY 83 and will be completed within six months from now.

To determine the expected trend of labor costs, the pricing personnel in the AFPRO use a G.E. "canned" program for "exponential smoothing" of past actuals (Atch 3). The system gives added weight to the more recent experience. Since the "more recent experience" at P&W GPD is preplanned to include generous step-ups in pay (see P&W internal correspondence on 1982 Salary Increase Programs, Atchs 4 & 5), it seems to me that the G.E. system in use would accelerate the upward curve of the projections over time. This will ultimately result in an asymptotic line rising perpendicularly on the graph. The only "control" used by wage rate analysts in P&W GPD AFPRO is a subjective comparison with Data Resources, Inc. (DRI) forecast data to be sure that in-house data is moving in the same direction as, and not contradictory to, the DRI forecasts. This comparison of the general direction of trends is also limited by the price analysts' lack of comparative factual data pertaining to specific elements such as COLA, merit pay increases, general increases, etc. The price analysts recognize and allow for the cost of P&W GPD expected promotions, merit increases, etc. on the basis provided to them by the contractor (ref to Atchs 4 & 5). During the discussions, we elicited the fact that no provision is made with respect to the decrease factor associated with the attrition of long-service employees as a result of retirements and other causes, although such employees are generally replaced by personnel at lower salary levels. Overall, I could only conclude from the lengthy discussions that the AFPRO pricing forecasts are bound to come out close to those input to them by the contractor. That conclusion is supported by comparison of the P&W proposed rates for 1982 with the rates recommended by the AFPRO price analysts, as follows:

	P&W	AFPRO	Differences Increase (Decrease)
Engineering			
Salary Non-Exempt	9.99	10.08	.09
Salary Exempt	16.95	16.92	(.03)
Treasury	26.64	26.69	.05
Manufacturing			
Hourly	10.77	10.72	(.05)
Test			
Hourly	12.16	12.10	(.06)
Salary Non-Exempt	11.27	11.25	(.02)
Salary Exempt	16.95	16.94	(.01)
Quality			
Hourly	10.93	10.94	.01
Salary Non-Exempt	9.11	9.52	.41
Salary Exempt	15.08	14.89	(.19)
Tooling			
Hourly	11.29	11.20	(.09)
Assembly			
Hourly	11.02	10.97	(.05)

The price analysts' recommendations do not differ from the P&W proposals in any meaningful way.

The Procurement Contracting Officer (PCO) has delegated to the AFPRO the authority to negotiate forward pricing rate agreements. The agreements reached between the AFPRO and the contractor are binding on the PCO. However, the AFPRO's capability to negotiate effectively is restricted by their interpretation of the terms of the DAR which provides for "flow down: of the "rules" at the Stamford, Connecticut, headquarters of UTC, see DAR 15-203(b)(1) and 15-203 (b)(5) as highlighted in Atch 7. Also see the Corporate Administrative Contracting Officer's 4 Nov 81 letter to the P&W AFPRO, Atch 8.

The AFPRO personnel believe it to be impracticably difficult to raise a challenge to P&W GPD proposed rates on the grounds that they are already unreasonable or that newly proposed increases are unreasonably high. They highlighted the underscored portion of DAR 15-205.6(a)(2) for us (Atch 9) in explaining their views. Note that they seem to rely on only the first part of the sentence, as though the highlighted portion were the whole thing. The sentence goes on to describe compensation as being reasonable when it "... conforms generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area, for similar services." That is, the DAR states that the compensation in general should conform to other firms /not necessarily aerospace/ of the same size; or to other firms /not necessarily of the same size/ in the same industry; or to other firms /not necessarily of the same size nor the same industry/ in the same geographic area. The provision concerning "... the same geographic area ..." is exactly in line with Administration policy in regard to the Davis-Bacon Act and, as I recommended in my 13 July 1982 memorandum for you "Labor Rates in Production of Aerospace Weapons Systems", should be employed in compensation reviews and our evaluations of contractors' proposed labor rates.

The pricing personnel provided us with the "Contractor's Logic" employed in the P&W "going-in" position for Forward Pricing Rates in Calendar 1982 negotiations (Atch 10) which says in part, "... 9.5% escalation was applied in August of CY 82, 4% escalation was applied in Jan CY 83 and CY 84, and an 8% escalation was applied in June 83 and 84 ..." Or, in tabular form:

Aug 82 ----- +9.5%
Jan 83 ----- +4.0%
Jun 83 ----- +8.0%
Jan 84 ----- +4.0%
Jun 84 ----- +8.0%

Jim Ririe noted that the first three added to 21.5% (without compounding) in only 11 months. When compounded, the three increases amount almost exactly to 23% over 11 months; or a straight line projection of more than 25% per year. None of the AFPRO personnel seemed to think that those rates of increase are unreasonable.

The Directorate of Management Analysis reported in May 1982 that an analytical study showed that aerospace labor rates are currently 44% above other manufacturing and 39% above durable goods Bureau of Labor Statistics (BLS) categories. Since P&W GPD is not out of line with other aerospace contractors, there is no element of catch-up or get-well in the P&W proposed rate increases. Accordingly, wage/salary increases at an annual rate of 25% are clearly unreasonable in an environment where inflation for the 12 months ended 30 June 1982 was 7.1% (BLS-CPI).

Perhaps more significantly, none of the AFPRO personnel seemed to feel that there was any way to address in negotiations the notion that the wage/salary base to which the percentage pay increases are to be applied is also unreasonably high in the first place.

With respect to union labor, as of 30 June only 1094 personnel of 6959, or 15.7%, were union members, and only 1602, or 23%, were covered in the bargaining unit. Thus, there would seem to be no persuasive argument that efforts to introduce conservative wage restraint at P&W GPD would lead to "union problems". This plant has no great union clout on hand, but with or without the added factor of union opposition I believe that since wage rate negotiations are imminent, this is an ideal place for the Air Force to stand up and be counted in wage/salary negotiations with a contractor. We should bargain not with respect to what the contractor will pay his employees, which is his business, but how much of that we will accept as reasonable, and agree to pay, in our fiduciary management of the taxpayers' funds.

Colin D Parfitt

Attachments

COLIN D. PARFITT

	DIRECT													
	SALARY	HOURLY	SRS	TOTAL	SALARY	HOURLY	SRS	TOTAL	SALARY	HOURLY	[illegible]			
[illegible]	1,737		155	1,892	130		64	194	1,867		219	2,086	ENGINEERING	
[illegible]					12			12	12			12	〃	TEST COMPUTERS
[illegible]					4			4	4			4	〃	DSGN GRAPHICS
[illegible]		650		650	429	34	22	485	429	684	88	1,136	MFG/ASSY	
[illegible]	262	185		447	22	17	11	50	284	.202	11	497	TEST	
[illegible]	50	193		243	80	23	5	108	130	216	5	351	INSPECTION	
[illegible]	28	1		29					28	1		29	OFF SITE	
[illegible]					151	114	7	272	151	114	7	272	MATERIAL O/H	
[illegible]					577	75	144	796	577	75	144	796	G&A	
[illegible]					654		51	705	654		51	705	PS - PRODUCT SUPPORT	
[illegible]					63		37	100	63		37	100	AS+PROGRAMS(ADVANCED SYSTEMS)	
[illegible]					221		16	237	221		16	237	MANAGEMENT SERVICES	
[illegible]					120	220	5	345	120	220	5	345	PLANT ENGR.	
[illegible]					88		4	92	88		4	92	MAIN COMPUTING SYS	
[illegible]					160		10	170	160		10	170	SYS + PROGRAMMING	
[illegible]					7		4	11	7		4	11	INFO SYS RESOURCE MGMT	
[illegible]	5			5	49	12	4	65	54	12	4	70	POWER SYSTEM DIV.	
	2,082	1,029	155	3,266	2,767	495	384	3,646	4,849	1,524	539	6,912		

PRATT & WHITNEY AIRCRAFT PRIVATE

* SETUP, CORRELATE DATA FROM TEST AREAS AS ENGINES ARE RUNNING

RECEIVED
JUL 14 1982
AFPRO-WPB

Atch 1

AS of June 1982

Salary Direct	H	SE	NE	SRS
Eng		1346	383	155
~~Fed Comp~~				
Mfg	649			
Test	183	91	165	
Insp	192	17	33	
OP	1	24	4	
~~Mat'l~~	-			
	1025	1478	590	155

3248

	H	SE	NE	SRS	
Eng Indirect		40	90	65	
Fed Comp		12			
Design		4			
Mfg	34	251	178	22	
Test	16	6	16	10	
Insp	24	61	19	5	
Mat'l	115	56	95	7	
G+A	71	387	208	146	
PS		615	148	51	includes Saudi + Egypt
Mktg/Adv		44	20	39	
Support Ser		106	115	17	
PE	221	58	62	5	
[illegible] Comp		44	45	4	
Syst Prog		107	51	10	
Admin		5	2	4	
	481	1796	1049	~~389~~ 385	

3711

6959

[illegible]

EXSM
EXP-SMOOTHING

EXPONENTIAL SMOOTHING

This routine is a sophisticated forecasting program which forecasts the action of a time-series variable. The method applied is called exponential smoothing.

Exponential smoothing performs an intrinsic type of analyses on regular discrete time series and then synthesizes a forecast. A regular discrete time series is a series of distinct values of a variable or function recorded in chronological order at equally spaced (regular) time intervals. This routine performs a cyclic analysis which indicates any regularly recurring behavior as well as a trend analysis which indicates the prevailing tendency or direction. Human judgment, discontinuities, and results of other analyses can be interjected into both the analysis and synthesis through a base series.

A base series is a time series of values by which the history and forecast may be adjusted. Discontinuities may result from actions which are not readily predictable such as the death of a president, a strike, competitive activities, and other unsettling news. For example, if management knows that a new product is forthcoming which will boost sales by 5 percent, this fact should be incorporated as part of the forecast. Or if management is convinced there will be competitive price cutting this year, this fact also can be put into the forecast. Or if a multiple regression analysis shows that sales increase at a rate of 10 percent per month starting the second month after a new government contract announcement to customer, then this relationship may also be interjected in the forecast via base series.

EXSM is merely a convenient way for calculating moving averages. It is useful for smoothing data, for forecasting prevailing general tendencies (trend), and for determining relationships between past and future data. It is useful for an unlimited variety of applications commonly of interest to management in many matters connected with the operation of a business. Typical applications include forecasting of: sales, profits, prices, customer demand, inventory levels, production loads, growth, economic indicators, natural phenomena, and physical phenomena.

The routine follows four fundamental steps to provide useful predictions:

- cyclic analysis of past data
- trend analysis of past data
- error analysis for comparing forecast with actual data
- synthesis of analyses to form a forecast

The eight types of output (printout schedules) which appear are as follows:

- raw data input listing
- cyclic analysis
- cyclic components
- residue of raw data less base series less cyclic effects

- smoothed absolute deviation for alpha and smoothing type
- composite forecast
- forecast constants
- least squares fit

SYNTAX

```
? RUN▲EXSM (tvar,bsvar) lead,fper,cyc,k [,s1,s2,s3]
```

Variables

tvar – This is the name of a time series variable. This time series represents the actual values of the phenomenon which is to be forecast. The routine assumes sequential numbering of time periods, starting at 1. Note: The limit on the number of data entries for this variable is 1000.

bsvar – This variable, if desired, is the base series. The base series represents actual values rather than index values. The routine subtracts these values from the raw data before an analysis is made and later adds them back into the forecast. (This variable does not need to be present for all runs.)

Required Scalars

lead – This scalar is the lead time. Lead time is the forecast interval or length of time in the future for which it is desired to compute a forecast accurately (see Figure 4). The forecast and forecasting parameters are optimized over the lead time. The longer the lead time, the more subject the forecast is to error.

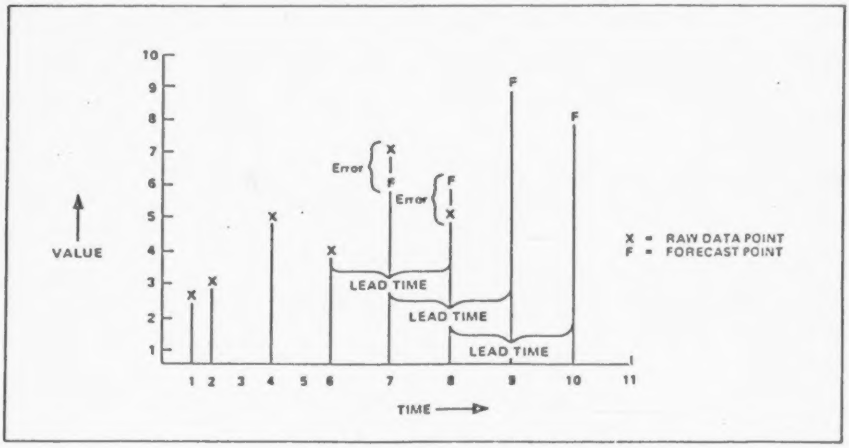


Figure 4. LEAD TIME ILLUSTRATION

fper – This scalar is the horizon forecast periods. Forecast horizon is the length of time in the future for which the forecast is to be extended. The forecast horizon has nothing to do with an optimal choice of the smoothing constant alpha. For example, if the raw data is reported monthly and you wish to forecast six months in the future, accurately, and also wish to take a casual glance at the forecast one year out, a lead time of 6 and a horizon of 12 should be specified.

cyc – This scalar indicates the cyclic analysis desired. This scalar permits you to specify cycle length of known periodic data and thus to override the section of cyclic analysis which computes length of the most predominant cycle.

cyc = -1	Automatic calculation for duration of the cycle
cyc = 0	No cyclic analysis
cyc = > 1	Any other number is forced duration of the cycle

k – This scalar controls printing. The output options starting with 1 are cumulative.

k = -2	Produces the same question as *k* = -1, preceded by a short description of each of the eight schedules.
k = -1	Prints the question 8 CONTROL NUMBERS--? which allows you to specify any combination of schedules. You must enter 8 responses. The eight responses relate to the schedule number, for example, the 5th response governs schedule 5. Enter either a 0 or a positive number for each of the eight schedules. A 0 is entered for each schedule not to be printed, and a 1 (or other integer greater than 0) is to be entered for each schedule to be printed. The one exception is for schedule 6; when a negative number is given, it has the same effect as a 0 except that for schedule 6 a truncated summary of the forecast is produced with all historical data omitted.
k = 0	Prints simple forecast table (portion of schedule 6).
k = 1	Prints a table of forecast values (schedule 6).
k = 2	Prints actual data (schedules 1,6).
k = 3	Prints tabulation of unsmoothed residue and cyclic analysis (schedules 1,2,3,4,6).
k = 4	Prints selection of alpha and smoothing type (schedules 1,2,3,4,5,6).
k = 5	Prints forecast constants and least squares fit (schedules 1 to 8).

Optional Scalars

s1 – The first optional scalar indicates the type of smoothing to be forced. This scalar allows you to specify the order of smoothing and thus to override the section of the program which selects it. The default value for *s1* = 0.

s1 = 0	No forcing for the type of smoothing.
s1 = 1	Type 1 smoothing is forced. Use if residue is flat (no upward or downward trend – horizontal line).

s1 = 2 Type 2 smoothing is forced. Use if residue is linear (steady trend – line crosses a horizontal line).

s1 = 3 Type 3 smoothing is forced. Use if residue is accelerating or decelerating (parabola).

s2 – This optional scalar controls the plot and the file for plot information. The default value for *s2* = 0 (two questions appear on the terminal).

s2	Plot	File
0	query	query
1	yes	yes
2	yes	no
3	query	yes
4	no	yes
5	yes	yes
6	no	no

s3 – This optional scalar is operative only when *cyc* is greater than 1, i.e., when cycle duration is forced. The default value for *s3* = 0.

s3 = 0 Computes cyclic components by its usual procedure.

s3 = 1 Indicates a single value for the smoothing constant "alpha" is to be used both for computing cyclic components and for smoothing the residue. The question WHAT ALPHA is printed, to which you respond with a value from 0 to 1. (As the alpha value approaches 1, less weight is given to past history.)

EXAMPLE 1

For an explanation of the data used in this analysis, see the example for the GROTRS routine.

```
READY
?RUN EXSM (PUNEM)

VERSION    76 MAR 08

ENTER LEAD TIME --?1

THIS ENTRY CAN BE MADE AS SCALR(1) IN SUBSEQUENT RUNS.

ENTER HORIZON FORECAST PERIODS --?4

THIS ENTRY CAN BE MADE AS SCALR(2) IN SUBSEQUENT RUNS.

ENTER CYCLIC ANALYSIS OPTION:
-1=AUTOMATIC,  0= NO CYCLE,  ANY NUMBER>0=FORCED CYCLE

?-1

THIS ENTRY CAN BE MADE AS SCALR(3) IN SUBSEQUENT RUNS.
```

```
ENTER PRINT OPTION, 0  TO 5

?5

THIS ENTRY CAN BE MADE AS SCALAR(4) IN SUBSEQUENT RUNS.

WANT TO SET SMOOTHING CONSTANTS?  YES OR NO --?NO


 NUMBER OF RAW DATA POINTS-- 10
NUMBER OF BASE DATA POINTS--  0
FORECAST HORIZON--  4
LEAD TIME--  1
```

always is printed

```
 TIME    RAW DATA
  1       41.100
  2       56.200
  3       54.500
  4       60.400
  5       72.200
  6       84.400
  7       90.000
  8       100.00
  9       107.80
 10       126.50
```

schedule 1 – raw data and base series adjustments, if any

schedule 2 – error value for each cycle duration

```
DETERMINATION OF THE OPTIMUM NUMBER OF DATA POINTS PER CYCLE:

  K       ERR(K)
  1       3.9259
  2       3.1915
  3       4.9322
  4       1.8439
  5       6.1858


OPTIMUM PERIOD FOR THE CYCLE =     4
```

schedule 3 – cycle terms for the selected length of cycle

```
  T        C(T)
  1       16.175
  2       1.9500
  3       7.9500
  4       9.8000
```

Summation of C(T)
0 + 16.175 = 16.175
16.175 + 1.9500 = 18.125
18.125 + 7.9500 = 26.075 etc.

```
TABULATION OF THE ACTUAL (UNSMOOTHED) RESIDUE:

TIME      RESIDUE
  1       41.100
  2       40.025
  3       36.375
  4       34.325
  5       36.325
  6       32.350
  7       36.000
  8       38.050
  9       36.050
 10       38.575
```

schedule 4 – residue, after correction for base series and cycle

Residue = Raw data – Summation of C(T)
41.100 = 41.100 – 0
40.025 = 56.200 – 16.175
36.375 = 54.500 – 18.125
34.325 = 60.400 – 26.075 etc.

schedule 5 – tabulation of smoothing constant and type of smoothing with corresponding smoothed absolute deviation.

Alpha approaching 1.0 gives strongest emphasis on most recent data points. Alpha approaching 0.0 gives all the data points approximately equal emphasis.

```
EXPONENTIAL SMOOTHING APPLIED TO THE RESIDUE:

                                        SMOOTHED
                                        ABSOLUTE
                     TYPE OF            DEVIATION
  ALPHA             SMOOTHING         PER DATA POINT
 0.01000                1                5.7521
 0.01000                2                5.5095
 0.01000                3                5.2715
 0.05000                1                4.8246
 0.05000                2                3.9926
 0.05000                3                3.6589
 0.12500                1                3.7539
 0.12500                2                3.1873
 0.12500                3                3.2664
 0.25000                1                3.1900
 0.25000                2                2.9162
 0.25000                3                2.3881
 0.37500                1                2.9141
 0.37500                2                2.4923
 0.37500                3                2.2101
 0.50000                1                2.8025
 0.50000                2                2.5548
 0.50000                3                2.7666
 0.62500                1                2.7796
 0.62500                2                2.9021
 0.62500                3                3.8165
 0.75000                1                2.8421
 0.75000                2                3.4516
 0.75000                3                5.5677
```

schedule 6 – summary of forecast; this summary can be restricted to the projection with all "history" excluded by using a negative control number

```
                                        SMOOTHED
                                        ABSOLUTE
 OPTIMUM             TYPE OF            DEVIATION
  ALPHA             SMOOTHING         PER DATA POINT
 0.37500                3                2.2101

------------------------------FORECAST-------------------------------
TIME     RESIDUE     COMPOSITE      ACTUAL       ERROR      % ERROR
  6       33.759      85.809        84.400      -1.4085      -1.64
  7       30.586      84.586        90.000       5.4140       6.40
  8       34.345      96.295        100.00       3.7048       3.85
  9       38.242      109.99        107.80      -2.1919      -1.99
 10       37.130      125.05        126.50       1.4453       1.16
 11       39.442      129.32
 12       40.879      138.70
 13       42.535      150.16
 14       44.408      168.21
```

Deviations computed are weighted distances of the actual from the composite values.

```
        S1               S2               S3
     37.15756         36.69814         36.84388

       CED1             CED2             CED3
     37.15756         37.61698         38.22213

        C2               C3               RC3
      0.27565          1.11076          0.21786
```

schedule 7 – parameters used for next forecast (Definitions of these terms can be found on pages 487-488.)

```
HORIZON FORECAST BEGINS AT TIME  12 <----------------

    LEAST SQUARES CURVE FIT  <------------------------
Y=      30.700 +         8.8382*X

     MEAN      VARIANCE
    79.310       662.46

WANT A PLOT?  YES OR NO --?NO

WANT PLOT DATA STORED?  YES OR NO --?YES

ENTER NAME OF FILE FOR PLOT DATA --?QPUNEM
```

always is printed

schedule 8 – least squares fit of a line to the raw data. The slope exhibited here shows the "average" change per time period in the data.

EXAMPLE 2

This example shows the use of scalars.

```
READY
?RUN EXSM(PUNEM)1,4,-1,-1

VERSION    76 MAR 08

8 CONTROL NUMBERS --?0,0,1,1
?0
?-1
?0
?0

WANT TO SET SMOOTHING CONSTANTS?  YES OR NO --?YES

ENTER NUMBER OF CONSTANTS, VALUES --?11, .25,.275, .3, .325, .35, .375, .4,

? .425, .45, .475, .5

 NUMBER OF RAW DATA POINTS-- 10
NUMBER OF BASE DATA POINTS--  0
FORECAST HORIZON--  4
LEAD TIME--  1

OPTIMUM PERIOD FOR THE CYCLE =     4

  T       C(T)
  1      16.175
  2      1.9500
  3      7.9500
  4      9.8000
```

```
TABULATION OF THE ACTUAL (UNSMOOTHED) RESIDUE:

TIME     RESIDUE
  1       41.100
  2       40.025
  3       36.375
  4       34.325
  5       36.325
  6       32.350
  7       36.000
  8       38.050
  9       36.050
 10       38.575

                                        SMOOTHED
                                        ABSOLUTE
OPTIMUM              TYPE OF           DEVIATION
 ALPHA              SMOOTHING        PER DATA POINT
0.32500                 3                2.1664

----------FORECAST----------
TIME      RESIDUE      COMPOSITE
 11        38.953        128.83
 12        40.056        137.88
 13        41.319        148.94
 14        42.743        166.54

HORIZON FORECAST BEGINS AT TIME  12

WANT A PLOT?  YES OR NO --?YES

WANT PLOT DATA STORED?  YES OR NO --?NO


 + = ACTUAL
 * = FORECAST
     84.40          104.94             125.47             146.01       166.54
  Y------------------^------------------^------------------^-----------------Y
 6+*
 7 *   +
 8          *   +
 9                     +*
10                                     * +
11                                         *
12                                                 *
13                                                           *
14                                                                           *
```

DATA MANAGEMENT

DIFF, UNW, and ZO help you manage your data. UNW and ZO alter your database; DIFF gives you an option to alter the database by storing the newly created differences.

PRATT & WHITNEY AIRCRAFT GROUP
Government Products Division

Internal Correspondence

To: All Salaried Supervisors
From: Frank W. McAbee, Jr.
Subject: 1982 Salary Program
Date: February 9, 1982

Attached to this memorandum is a General Notice which will be posted in the next few days. This year, as we planned our 1982 Salary Increase Program, we had to place more emphasis than usual on the severity of the business climate and competitive pressures that can erode our market share. I consider it vital that we employ these funds in the most cost effective way possible, so that our program is seen as tied solidly to our philosophy of pay for performance. Quite literally, our futures may depend upon the effectiveness of our efforts.

The 1982 Salary Increase Program has been designed so that substantial funds are available to reward our better performers. For the most part, no increase less than 7% should be awarded in 1982. Although the rate ranges have not been adjusted in 1982, employees currently paid at or near the maximum of their rate ranges may be allowed to exceed the maximum. However, no increase greater than 7% may be awarded in such cases.

The program procedures and schedule remain basically unchanged from last year. Instructional and work material will be distributed within the next few days. Definitions of performance level categories used in the 1982 program are described in the General Notice.

Because of the importance of the program, I have asked Len Black and his designates to conduct briefings for all salaried supervision prior to the posting of the General Notice. If you have any questions, I am certain that they can be answered in these briefings.

Frank
Frank W. McAbee, Jr.

[illegible]
nment Products Division
UNITED TECHNOLOGIES

GENERAL NOTICE

SUBJECT: 1982 SALARY PROGRAM

In December I informed you that business and competitive pressures will be even greater this year than last. All projections indicate 1982 will be a difficult and demanding year for our Division, one that will test us as we have not been tested previously. Significantly improved productivity is essential if we are to be competitive. I am pleased to announce that, in spite of these pressures, we will have an attractive salary program for 1982. However, the unusual challenges we face demand the greatest possible return on the salary increase dollars spent. To that end, we have established the 1982 program on a total merit basis with no special salary adjustment. The salary changes must be awarded where they are deserved and will have the greatest positive impact on productivity. Perhaps more than ever, this year's program will be carried out in the pure spirit of our long-standing philosophy of "pay for performance." Below are principal highlights of the program.

- Salary increases will range up to 16%. While it is difficult to predict accurately what the average increase will be, we expect that the vast majority of employees who participate in the 1982 program will receive at least a 7% increase, and half our employees will receive increases of 9% or better.

- Last year we enjoyed a participation rate of 94% and this year we anticipate that the same percentage of salaried employees will receive a salary increase. However, no increase will be awarded to employees rated less than Good in their 1982 Performance Appraisal. The performance categories against which all employees will be evaluated this year are as follows:

  1. OUTSTANDING - Rarely achieved. Employee consistently and substantively exceeded the normal requirements of the job in all areas.

  2. EXCELLENT - Employee frequently exceeded normal requirements of the job in all key areas. Quantity and quality of work was superior.

  3. GOOD - Employee fully and consistently met all normal job requirements in accordance with established standards and may have surpassed requirements in some areas. (Includes new, developing employee who has performed assigned tasks in fully acceptable manner but has not yet been exposed to the full scope of the job.)

  4. BELOW EXPECTATIONS - Employee did not meet all normal established standards for the job. Overall performance was minimally acceptable, but substantive improvement is needed.

  5. UNACCEPTABLE - Employee did not meet minimum job requirements and required continuous direction. Overall performance was unacceptable and needs immediate improvement.

- As in the past, a second review period can be used to accommodate additional rewards for top performers, to acknowledge dramatically improved performance, and to provide equitable consideration for those employees whose salary increase decisions are affected by new-hire status, promotion or other factors. The first review begins in February with resulting salary changes to become effective during April through June, and the second review starts in July with salary changes to become effective in September through December.

- The variable effective dates for increases are influenced by individual performance level, time since last increase or promotion and other pertinent considerations. Normally employees should receive salary changes in cycles of 12 months with some variation dependent on demonstrated performance or recent promotion.

I intend to see that we apply our 1982 salary increases in a manner that rewards performance and provides incentive to help meet the challenges of the coming year. We need your effort to make 1982 the successful year that it can be.

Frank

F. W. McAbee, Jr.
President

February 9, 1982
CN# 15-82
Distribution: All Salaried Supervision
All Salaried Bulletin Boards (Remove 2/19/82)

PRATT & WHITNEY AIRCRAFT GROUP
Government Products Division

Internal Correspondence

To: I. M. Cook
W. B. Bowden - Finance
J. P. Roberson - Customer Requirements & Support
D. C. Colby - Operations
J. A. Elliott - Product Integrity
C. V. Stephenson - Engineering
H. Ugalde - Divn. Administration & Personnel
From: I. Weinberg
Copy to: F. W. McAbee, Jr., Joe R. Phillips L. E. Black,
S. Curvino, L. L. DeSantis, H. S. Harvey,
B. L. Koff, J. F. McDermott, W. S. Parker,
M. Z. Zipkin
Subject: 1982 Salary Increase Program (Grades 31-51)
Date: 9 February 1982

To assist you in implementing the 1982 salary increase program for employees in grades 31 to 51 we are providing the following material for each salary rater:

- computer tab run for salary recommendations
- program guidelines
- 1982 salary increase guide
- Performance Appraisal/Salary Recommendation forms

Also attached for your use is a schedule of key dates for the first review period. All of the information should be distributed to appropriate supervisors as soon as possible. Should you require additional information, please notify me.

Note that the tab runs enclosed should be completed and returned to Compensation by February 22.

Please caution your supervisors to ensure effective control of this material. Recipients should be made aware of its private nature and SHOULD NOT REPRODUCE OR POST ANY PORTION OF IT. Of course, the nature of the program should be discussed by supervision with employees at an appropriate time, but these materials are not intended to be used during such individual employee reviews.

I. Weinberg
Manager, Compensation
and Organization

IW:cvg

atch

atch 5'

GOVERNMENT PRODUCTS DIVISION

1982 SALARY PROGRAM GUIDELINES

FIRST REVIEW PERIOD

GRADES 31-51

1. Salary increase percentages and effective dates should be consistent with the Salary Increase Guide (attached) and Mr. McAbee's recommendation that employees should receive salary changes in cycles of approximately 12 months. Recommended variances must have strong written substantiation.

2. The magnitude of each increase granted is a function of performance level only, except that no increase may result in a salary level that exceeds the range maximum for the grade by more than 7%. No increase greater than 7% may be awarded if such increase would exceed the established range maximum.

3. Increases awarded in the two review periods of 1982 should have effective dates as follows:

1st Review	2nd Review
50% effective 1 April	40% effective 1 September
30% " 1 May	30% " 1 October
20% " 1 June	20% " 1 November
	10% " 1 December

4. As in the past, you will be provided a computer tabulated listing of your employees. You need to make entries only in three (3) columns. Under "Proposed Salary" enter each employee's recommended new salary, or an "X" if no increase is recommended. Use monthly salaries for Grades 31-48, and annual salaries for Grades 49-51. Enter suggested salary change date under "Effective Date" and enter the appropriate performance level (1=Outstanding, 2=Excellent, 3=Good, 4=Below Expectations, 5=Unacceptable) in the column headed "PL." Please note that a performance level must be entered for every employee. Performance levels do not relate to a numerical distribution of population, but should represent each employee's demonstrated level of performance measured against your established standards. The level you indicate on the computer listing for each employee must be consistent with the overall assessment eventually shown on the Performance Appraisal/Salary Recommendation form. The distribution of employees within performance categories on a division-wide basis is expected to be approximately:

7% - Outstanding
30% - Excellent
56% - Good
6% - Below Expectations
1% - Unacceptable

This does not mean that each operating unit or entity must reflect this distribution. To the contrary, small groups likely will not.

5. The computer run will be your primary tool for salary planning. The required substantiation to implement your plan will be the completed Performance Appraisal/Salary Recommendation forms. Salary increases will not be implemented unless the appraisal form is received. Approved forms are to be submitted to Compensation approximately six (6) weeks prior to the planned effective date except as indicated in the attached schedule.

6. A complete performance appraisal is to be prepared for all salary employees in Grades 31-51 during this first review period. Appraisal forms on all employees rated Below Expectations or Unacceptable should be submitted to Compensation by 3/15/82.

7. Of particular note is the fact that there will be two Performance Appraisal/ Salary Recommendation forms. The forms are very similar but one applies to Grades 31-40 and the other to Grades 41-51. The differences in the forms are the skill factors listed in the Individual Skill Profile portion at the lower left. Definitions of those factors are included herewith for your use.

GOVERNMENT PRODUCTS DIVISION

SALARY INCREASE GUIDE

GRADES 31-51

1982

LEVEL OF PERFORMANCE	PERCENT INCREASE RANGE
OUTSTANDING - Rarely achieved. Employee consistently and substantively exceeded the normal requirements of the job in all areas.	14-16%
EXCELLENT - Employee frequently exceeded normal requirements of the job in all key areas. Quantity and quality of work was superior.	10-15%
GOOD - Employee fully and consistently met all normal job requirements in accordance with established standards and may have surpassed requirements in some areas. (Includes new, developing employee who has performed assigned tasks in fully acceptable manner but has not yet been exposed to the full scope of the job.)	7-11%
BELOW EXPECTATIONS - Employee did not meet all normal established standards for the job. Overall performance was minimally acceptable, but substantive improvement is needed.	-0-
UNACCEPTABLE - Employee did not meet minimum job requirements and required continuous direction. Overall performance was unacceptable and needs immediate improvement.	-0-

* NOTES:

1. For the most part, no increase less than 7% should be awarded. No increase greater than 7% may be awarded if it will exceed the maximum of the salary range.

2. Consideration of all factors in individual cases may indicate that no increase can appropriately be recommended at this time even though performance may be Good or better. Any employee whose performance is rated at Below Expectations or Unacceptable should not receive a salary increase.

3. Employees in lower level non-exempt grades may warrant consideration for increases more often than higher grade employees. In all cases, individual performance should be the primary determinant of frequency and size of salary changes. For employees high in the salary range, particularly those in Grades 41-51, the large majority of increases should not be awarded at less than 12 month intervals. Confer with Compensation regarding top performers or other special cases that you feel warrant an abnormally short interval between increases.

* These guidelines apply in a vast majority of cases. Actions you propose that differ from them will be treated as exceptions, and should be discussed in advance with your Compensation Administrator.

DEPARTMENT OF THE AIR FORCE
AF PLANT REPRESENTATIVE OFC (DET 4), AF CONTRACT MGT DIV (AFSC)
PRATT & WHITNEY AIRCRAFT, P.O. BOX 2691
WEST PALM BEACH, FL 33402

PLY TO TTN OF THF 19 July 1982

UBJECT Preliminary Recommendations for P&WA/GPD Labor Rate Proposal Dated 14 June 1982 (CH82-004)

TO AFPRO P&WA/TMF

1. This memo is issued to recommend labor rates for CY 81 through 82. The DCAA-WPB have been requested, by AFPRO/TMO letter dated 23 June 1982 to perform a review of the referenced proposal. This memo will establish interim labor rates until receipt of the DCAA report and further analyses at that time.

2. The following is a summary of the AFPRO recommendations.

	Recommended (a)			
	1981	1982	1983	1984
Engineering				
Salary Non-Exempt	$9.32	10.08	11.19	12.43
Salary Exempt	15.67	16.92	18.27	19.66
Treasury	25.40	26.69	28.54	30.36
Manufacturing				
Hourly	9.83	10.72	11.58	12.44
Test				
Hourly	11.11	12.10	12.95	13.81
Salary Non-Exempt	10.62	11.25	12.12	13.00
Salary Exempt	15.81	16.94	18.28	19.64
Quality				
Hourly	9.91	10.94	11.83	12.69
Salary Non-Exempt	8.80	9.52	10.57	11.74
Salary Exempt	13.80	14.89	16.07	17.29
Tooling				
Hourly	10.30	11.20	12.04	12.93
Assembly				
Hourly	10.14	10.97	11.82	12.68

(a) The contractor's proposed versus the AFPRO recommendations, plus pertinent details and comments are included in Atch 1.

3. The contractor's latest amendment to his Disclosure Statement dated 22 Apr 81, which considered CAS 418, was determined to be adequate on 11 May 1982.

4. The contractor's Procurement System was approved for adequacy by ACO effective 17 June 82 for a period of one (1) year.

5. Questions regarding this review may be referred to Charles Haas, ext 4476.

Charles H. Haas
CHARLES H. HAAS
Price Analyst

1 Atch
Stmt of Contractor's Proposal vs
Analyst's Recommendation

Cy to: AFPRO P&WA/TMO

STATMENT of CONTRACTOR'S PROPOSED LABOR RATES VERSUS AFPRO RECOMMENDATIONS

	PROPOSED				RECOMMENDED				DIFFERENCE (INCREASE)				
	1981	1982	1983	1984	1981	1982	1983	1984	1981	1982	1983	1984	NOTE
ENGINEERING					(a)								
SALARY NON-EXEMPT		9.99	11.48	12.89	9.32	10.08	11.19	12.43		(.09)	.10	.46	b
SALARY EXEMPT		16.95	19.46	21.86	15.67	16.92	19.27	19.66		.03	.19	2.20	b
TREASURY		26.64	30.57	34.34	25.40	26.69	28.54	30.36		.05	2.03	3.48	b
MANUFACTURING													
HOURLY		10.77	11.79	12.81	9.83	10.72	11.58	12.44		.05	.21	.37	c
TEST													
HOURLY		12.16	13.19	14.21	11.11	12.10	12.95	13.81		.06	.24	.40	c
SALARY NON-EXEMPT		11.27	12.92	14.50	10.62	11.25	12.12	13.00		.02	.80	1.50	b
SALARY EXEMPT		16.95	19.48	21.88	15.81	16.91	18.28	19.64		.01	1.20	2.24	b
QUALITY													
HOURLY		10.93	11.96	12.98	9.91	10.94	11.83	12.69		.01	.13	.29	
SALARY NON-EXEMPT		9.11	10.43	11.71	8.80	9.52	10.57	11.74		(.41)	(.14)	(.03)	b
SALARY EXEMPT		15.08	17.35	19.49	13.80	14.89	16.07	17.29		.19	1.28	2.20	b
TOOLING													
HOURLY		11.29	12.32	13.34	11.30	11.20	12.04	12.93		.09	.28	.41	c
ASSEMBLY													
HOURLY		11.02	12.04	13.06	10.14	10.97	11.82	12.68		.05	.22	.38	c

Explanatory Notes

(a) The recommended CY 81 labor rates reflect the actuals as recorded on the contractor's books of account.

(b) The contractor's proposed labor rates were based on the April annualized actual rates; (i) escalated in August of CY 82 at 9.5%, (ii) escalated in January of CY's 83 and 84 at 4% and (iii) escalated in June of CY's 83 and 84 at 8%. AFPRO recommended labor rates were estimated using current actuals through 30 June 1982. Our forecast employed "Double Exponential Smoothing." Exponential Smoothing is a technique for assigning exponentially declining weights to the observations to produce an exponential average. We used the actual labor rates from January 1978 to June 1982 to base our projection. Our analysis indicated the following increases:

	% Change	*	
	81 to 82	82 to 83	83 to 84
Engineering			
Non-Exempt	8.2	11.0	11.1
Exempt	8.0	8.0	7.6
Treasury	5.1	6.9	6.4
Test			
Non-Exempt	5.9	7.7	7.3
Exempt	7.1	7.9	7.4
Quality			
Non-Exempt	8.2	11.0	11.1
Exempt	7.9	7.9	7.6

*Our recommended escalation factors compare favorably with applicable current labor wage/price indices widely used in economic forecasting.

(c) The proposed/recommended hourly labor rates are based on the negotiated Union agreement (signed 24 January 1981) for hourly GPD employees for 1981-83. The difference between the proposed and recommended amounts represents Cost of Living Allowance (COLA) forecasting. The contractor forecasted the COLA to reach a 12 cent cap as indicated in the Union Contract. The previous three quarters received a COLA of 8 cents. Our forecast is based on the COLA computed from the CPI recorded from June 1981 to June 1982.

CONTRACT COST PRINCIPLES AND PROCEDURES

Part 2—Contracts with Commercial Organizations

15-201 Basic Considerations.

15-201.1 *Composition of Total Cost.* The total cost of a contract is the sum of the allowable direct and indirect costs allocable to the contract, incurred or to be incurred, less any allocable credits. In ascertaining what constitutes costs, any generally accepted method of determining or estimating costs that is equitable under the circumstances may be used, including standard costs properly adjusted for applicable variances.

15-201.2 *Factors Affecting Allowability of Costs.* Factors to be considered in determining the allowability of individual items of cost include (i) reasonableness, (ii) allocability, (iii) standards promulgated by the Cost Accounting Standards Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the particular circumstances, and (iv) any limitations or exclusions set forth in this Part 2, or otherwise included in the contract as to types or amounts of cost items. (But see 15-201.3(b)(4).) When a contractor has disclosed his accounting practices in accordance with Cost Accounting Standards Board Rules, Regulations, and Standards and any such practices are inconsistent with any of the provisions of this Part 2, costs resulting from such inconsistent practices shall not be allowed in excess of the amount that would have resulted from the use of practices consistent with this Part 2.

15-201.3 *Definition of Reasonableness.*

(a) *General.* A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of competitive business. The question of the reasonableness of specific costs must be scrutinized with particular care in connection with firms or separate divisions thereof which may not be subject to effective competitive restraints. What is reasonable depends upon a variety of considerations and circumstances involving both the nature and amount of the cost in question. In determining the reasonableness of a given cost, consideration shall be given to—

- (i) whether the cost is of a type generally recognized as ordinary and necessary for the conduct of the contractor's business or the performance of the contract;
- (ii) the restraints or requirements imposed by such factors as generally accepted sound business practices, arm's length bargaining, Federal and State laws and regulations, and contract terms and specifications;
- (iii) the action that a prudent business man would take in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the Government and the public at large; and
- (iv) significant deviations from the established practices of the contractor which may unjustifiably increase the contract costs.

(b) *Application of "Contractor Weighted Average Share in Cost Risk" (CWAS).*

(1) The cost principles contained in 15-205, or in certain cases their subparagraphs, carry either a "(CWAS)" or a "(CWAS-NA)" indicator. Those cost principles or subparagraphs subject to CWAS are preceded by the indicator

"(CWAS)" and those to which CWAS is not applicable are preceded by the indicator "(CWAS-NA)". In all cases where cost reasonableness is not determined under CWAS because of its express inapplicability, the determination will be made in accordance with (a) above. For CWAS qualified contractors, costs subject to those cost principles or subparagraphs designated "(CWAS)" will be presumed reasonable.

(2) The determination of cost reasonableness will be made in accordance with (a) above in all cases where the contractor could not qualify or does not choose to qualify under CWAS.

(3) The application of the CWAS applicable principles in 15-205 to indirect costs incurred in a profit center with CWAS qualification shall be determined in accordance with this subparagraph. Such costs shall be considered reasonable as to nature and amount, notwithstanding any specific limitations or exclusions based on standards of reasonableness contained in 15-205. For example, compensation for personal services (15-205.6(a)) shall be considered reasonable without regard to compensation paid by other firms (15-205.6(a)(2)). In addition, there are costs that are considered unallowable under 15-205 because they exceed a stated criteria of reasonableness. These criteria do not apply to indirect costs incurred in a profit center with CWAS qualification and the reasonableness of such costs shall not be questioned. For example, losses from a contractor's food and dormitory operations would be allowable notwithstanding the criteria in 15-205.10(c), or costs of idle facilities would be allowable notwithstanding the requirements of 15-205.12(b). Similarly, specific cost limitations, such as the 30-day limitation on advance trip time for relocated employees (15-205.25(c)(i)) or the 156-hour limitation for compensation for part time training (15-205.44(b)(v)) shall not apply to cost incurred in a profit center with CWAS qualification. Also, any requirement in 15-205 for contracting officer approval or instructions as a prerequisite to the allowability of certain cost (*e.g.*, 15-205.22(e)(2)) shall not apply.

(4) Questions involving the charging off of assets or setting up of other than normal year-end accruals or reserves will be considered to be questions of allocability or accounting practices rather than reasonableness.

(5) If the profit center incurs costs (*e.g.*, travel, relocation, personnel compensation) on the basis of prescribed corporate-wide policy uniformly applied to all profit centers, consideration should be given to the corporate CWAS qualification in determining the reasonableness of such locally incurred costs.

(6) The CWAS qualification for the company shall be used in testing the reasonableness of corporate type expenses which are allocated to the profit centers. If the contractor has intermediate management organizations, such as Groups, the CWAS qualification for such intermediate management organizations shall be applicable to the expenses allocated by such intermediate organizations to the profit centers.

(7) Indirect costs incurred in cost centers which are applied to specific contracts without relation to total profit center operations may be eliminated by the ACO from the application of CWAS.

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS AIR FORCE CONTRACT MANAGEMENT DIVISION (AFSC)
CORP ACO UNITED TECHNOLOGIES CORP, UNITED TECHNOLOGIES BLDG, HARTFORD CT 06101

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TMC 4 November 1981

United Technologies Corporation Compensation Program

AFPRO Det #4 PWAG/TM (Mr. H. J. Moyes)

1. Reference is made to a telephone conversation between Mssrs T. Shepard and T. Kevil of your office and the CACO on 4 November 1981.

2. As requested, a copy of the most recent Compensation System Review Report issued 16 Sep 80 by the DCASR Boston Financial Services Division is attached for your information. The compensation program, including policies and procedures covering salary schedules, surveys, establishing positions and position descriptions, evaluations, etc., is a corporate responsibility but is administered at each location. The compensation review addresses corporate policies and procedures that have been developed and promulgated and evaluates their adequacy and reasonableness. In this respect, Part D, entitled "Management of Compensation System" and Part E, entitled "Elements of the Employee Compensation System" conclude with a favorable opinion.

3. Notwithstanding the conclusion as to the adequacy of procedures and sufficiency of the compensation program to generate reasonable costs, it is incumbent upon each segment ACO to review segment compliance with established corporate policies and procedures. To accomplish this each segment has its own compensation review conducted by AFPRO or DCAS personnel to ascertain whether the segment is in compliance with the corporate program. The segment must make available to the PACO the corporate policies (with any segment deviations) to permit a review for compliance. Reasonableness should not be an issue unless the segment is in contravention with or deviating from corporate policy.

4. The attached report is marked "For Official Use Only" and should be protected as such. This letter is marked "For Official Use Only" solely because of the attachment. Upon removal of the attachment the protective marking is cancelled from this letter.

RF Parslow
R. F. PARSLOW
Corporate Administrative
Contracting Officer

1 Atch
Compensation System Review
Report

(ii) Compute the average annual B&P costs (hereafter called average), using the two highest of the preceding three years;

(iii) B&P costs for the center for the current year which are not in excess of the product of the center's actual total sales (or other accepted base) for the current year and the B&P historical ratio computed under (i) above (hereafter called product) shall be considered allowable only to the extent the product does not exceed 120% of the average. If the product is less than 80% of the average, costs up to 80% of the average shall be allowable.

(iv) Costs which are in excess of the ceiling computed in (iii) above are not allowable except where the ceiling computed for IR&D cost under 15-205.35 is reduced in an amount identical to the amount of any increase over the B&P ceiling computed in (iii) above.

However, at the discretion of the contracting officer, an advance agreement may be negotiated when the contractor can demonstrate that the formula would produce a clearly inequitable cost recovery. The requirements of (d)(2)(A) above are not mandatory for such agreements.

15-205.4 *Bonding Costs.* (CWAS)

(a) Bonding costs arise when the Government requires assurance against financial loss to itself or others by reason of the act or default of the contractor. They arise also in instances where the contractor requires similar assurance. Included are such bonds as bid, performance, payment, advance payment, infringement, and fidelity bonds.

(b) Costs of bonding required pursuant to the terms of the contract are allowable.

(c) Costs of bonding required by the contractor in the general conduct of his business are allowable to the extent that such bonding is in accordance with sound business practice and the rates and premiums are reasonable under the circumstances.

15-205.5 *Civil Defense Costs.*

(a) (CWAS) Civil defense costs are those incurred in planning for, and the protection of life and property against, the possible effects of enemy attack. Reasonable costs of civil defense measures (including costs in excess of normal plant protection costs, first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions, and other approved civil defense measures) undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor.

(b) (CWAS) Costs of capital assets under (a) above are allowable through depreciation in accordance with 15-205.9.

(c) (CWAS-NA) Contributions to local civil defense funds and projects are unallowable.

15-205.6 *Compensation for Personal Services.*

(a) *General.*

(1) (CWAS) Compensation for personal services includes all remuneration paid currently or accrued, in whatever form and whether paid immediately or

deferred, for services rendered by employees to the contractor during the period of contract performance (except as otherwise provided in 15-205.6(f)). It includes, but is not limited to, salaries, wages, directors' and executive committee members' fees, bonuses (including stock bonuses), incentive awards, employee stock options, employee insurance, fringe benefits, contributions to pension, annuity, and management employee incentive compensation plans, allowances for off-site pay, incentive pay, location allowances, hardship pay and cost of living differential. When the personal services are performed in a foreign country, compensation may also include overseas differential which may properly consider all expense associated with foreign employment such as housing, cost of living adjustments, transportation, bonuses, additional Federal, State, local or foreign income taxes resulting from foreign assignment and other related expenses. Although the aforementioned additional taxes may be considered in establishing overseas differential, any increased compensation calculated directly on the basis of an employee's specific increase in income taxes is unallowable. Except as otherwise specifically provided in this 15-205.6, such costs are allowable to the extent that the total compensation of individual employees is reasonable for the services rendered and they are not in excess of those costs which are allowable by the Internal Revenue Code and regulations thereunder. Differential allowances for additional Federal, State, or local income taxes resulting from domestic assignments are unallowable.

(2) (CWAS) Compensation is reasonable to the extent that the total amount paid or accrued is commensurate with compensation paid under the contractor's established policy and conforms generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area, for similar services. In the administration of this principle, it is recognized that not every compensation case need be subjected in detail to the above tests. Such test need be applied only to those cases in which a general review reveals amounts or types of compensation which appear unreasonable or otherwise out of line. However, certain conditions give rise to the need for special consideration and possible limitation as to allowability for contract cost purposes where amounts appear excessive. Among such conditions are the following:

(i) Compensation to owners of closely held corporations, partners, sole proprietors, or members of the immediate families thereof, or to persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise. Determination should be made that such compensation is reasonable for the actual personal services rendered rather than a distribution of profits. (CWAS-NA)

(ii) Any change in a contractor's compensation policy resulting in a substantial increase in the contractor's level of compensation, particularly when it was concurrent with an increase in the ratio of Government contracts to other business, or any change in the treatment of allowability of specific types of compensation due to changes in Government policy. (CWAS)

(iii) The contractor's business is such that his compensation levels are not subject to the restraints normally occurring in the conduct of competitive business. (CWAS)

(3) (CWAS) Compensation in lieu of salary for services rendered by partners and sole proprietors will be allowed to the extent that it is reasonable and does not constitute a distribution of profits.

(4) (CWAS) Notwithstanding any other provisions of this 15-205.6 costs of compensation are not allowable to the extent that they result from provisions of labor-management agreements that, as applied to work in the performance of Government contracts, are determined to be unreasonable either because they are unwarranted by the character and circumstances of the work or because they are discriminatory against the Government. The application of the provisions of a labor-management agreement designed to apply to a given set of circumstances and conditions of employment (for example, work involving extremely hazardous activities or work not requiring recurrent use of overtime) is unwarranted when applied to a Government contract involving significantly different circumstances and conditions of employment (for example, work involving less hazardous activities or work continually requiring use of overtime). It is discriminatory against the Government if it results in individual personnel compensation (in whatever form or name) in excess of that being paid for similar non-Government work under comparable circumstances. Disallowance of costs will not be made under this subparagraph (4) unless:

(i) the contractor has been permitted an opportunity to justify the costs, and

(ii) due consideration has been given to whether unusual conditions pertain to the Government contract work, imposing burdens, hardships, or hazards on the contractor's employees, for which compensation that might otherwise appear unreasonable is required to attract and hold necessary personnel.

(5) In addition to the general requirements set forth in (1) through (4) above, certain forms of compensation are subject to further requirements as specified in (b) through (i) below.

(b) *Salaries and Wages.* (CWAS) Salaries and wages for current services include gross compensation paid to employees in the form of cash, products, or services, and are allowable.

(c) *Cash Bonuses and Incentive Compensation.* (CWAS) Incentive compensation for management employees, cash bonuses, suggestion awards, safety awards, and incentive compensation based on production, cost reduction, or efficient performance, are allowable to the extent that the overall compensation is determined to be reasonable and such costs are paid or accrued pursuant to an agreement entered into in good faith between the contractor and the employees before the services were rendered, or pursuant to an established plan followed by the contractor so consistently as to imply in effect, an agreement to make such payment (but see 15-107). Bonuses, awards, and incentive compensation when any of them are deferred are allowable to the extent provided in (f) below.

(d) *Bonuses and Incentive Compensation Paid in Stock.* (CWAS) Costs of bonuses and incentive compensation paid in the stock of the contractor or of an affiliate are allowable to the extent set forth in (c) above (including the incorporation of the principles of paragraph (f) below for deferred bonuses and incentive compensation), subject to the following additional requirements:

(i) valuation placed on the stock transferred shall be the fair market value at the time of transfer, determined upon the most objective basis available; and

(ii) accruals for the cost of stock prior to the issuance of such stock to the employees shall be subject to adjustment according to the possibilities that the employees will not receive such stock and their interest in the accruals will be forfeited.

(e) *Stock Options.* (CWAS-NA) The cost of options to employees to purchase stock of the contractor or of an affiliate is unallowable.

(f) *Deferred Compensation.* (CWAS-NA)

(1) As used herein, deferred compensation includes all remuneration, in whatever form, for which the employee is not paid until after the lapse of a stated period of years or the occurrence of other events as provided in the plans, except that it does not include normal end of accounting period accruals. It includes (i) contributions to pension (including early retirement), annuity, stock bonus, and profit sharing plans, (ii) contributions to disability, withdrawal, insurance, survivorship, and similar benefit plans, and (iii) other deferred compensation, whether paid in cash or in stock.

(2) Deferred compensation is allowable only to the extent that:

(i) it is, together with all other compensation paid to the employee, reasonable in amount; and

(ii) it is paid pursuant to an agreement entered into in good faith between the contractor and employees before the services are rendered, or pursuant to a plan established and consistently applied thereafter by the contractor. Pension plans and other types of deferred compensation not covered by Part 415, Appendix O, are also subject to the provisions of (A), (B), and (C) below. Deferred compensation covered by Part 415, Appendix O, is not subject to the limitations of the Internal Revenue Code and regulations thereunder, but is subject to the provisions of (D) and (E) below.

(A) it is deductible for the same fiscal year for Federal income tax purposes under Section 404 (excluding subsection (a)(5)) of the Internal Revenue Code of 1954 as amended and the regulations of the Internal Revenue Service, *provided*, that

a. normal costs of pension plans incurred subsequent to the effective date of this paragraph, not funded in the year incurred, and pension costs or adjustments of previous years (past service) allocable to the current accounting period but not funded in such period shall not be allowable in subsequent years (except that a payment made to a fund by the time set for filing of the Federal income tax return for any taxable year shall be deemed to have been made during such taxable year). However, any portion of pension cost computed for a cost accounting period that is deferred pursuant to a waiver granted under the provisions of ERISA as set forth in CAS 412.50(C)(3) will be allowable in the future accounting period(s) in which the funding takes place.

Contractor Logic

The Contractor's proposed labor rates were based on the annualized actual rates through April '82 were used as base to develop the salary + hourly forward price labor rates.

Salary (all Cats) - 9.5% escalation was applied in August of CY'82, 4% escalation was applied in Jan. CY 83 and CY 84, and an 8% escalation was applied in June '83 + 84.

Hourly CY 82 + 83 based on Jan 24th Union Agreement. ~~CR~~ CY 83 Escalation were used in determining 84 rates. Summary of Terms of Agreement are as follows: 1.) Capped COLA of .12 per hour was applied in Feb., May, Aug., and Nov.. 2.) A .34 per hour wage increase was applied in Feb. CY 1983. 3.) An automatic progression of .10 per hour was applied in July + Dec. of '82 + 83.

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

12 August 1982

MEMORANDUM FOR MR. FITZGERALD

SUBJECT: Discrepant Explanations - Rotation of DCAA Audit Office Chief, Pratt & Whitney

Reference is made to my Memorandum for Record (MR), 21 July 1982 (Tab 1), pertaining to John Boddie's discussion with us about his telephone conversation with Mr. James R. Brown, Deputy Director of the Defense Contract Audit Agency (DCAA), on the question of the early rotation of Mr. George Spanton, Chief of DCAA's resident audit office, Pratt & Whitney Government Products Division, West Palm Beach, Florida.

The first of three specific points made by Mr. Brown was that the resident audit office chief had been in that position for more than the five years provided for in DCAA's general rules concerning mobility.

The foregoing point is absolutely contradicted by Mr. Brown's own letter of 11 May 1982 to Mr. George Spanton (Tab 2). The second paragraph of Mr. Brown's letter states, in part: "On 15 March 1982, at my request, you came to my office at Cameron Station and I asked you to describe ... My notes of this meeting as modified by you are enclosed as enclosure 2." The last three lines on page three of that Enclosure 2 deal with the subject of Mr. Spanton's rotation and commence with the statement, "Rotation date - March 1983 ..."

I also enclose herewith, Tab 3, a letter to Mr. Spanton from Mr. E. J. Hill, Chairman of DCAA's Career Management Board, 12 March 1982. The first paragraph of this letter reads:

> "As previously discussed between you and Arlin Tueller, Regional Audit Manager, the provisions of the Auditor Rotation Policy require your rotation five years after assignment, which will be no later than 18 March 1983."

With reference to your note of July 22 to General Driessnack, handwritten on a copy of my July 21 MR (Tab 1), I note that the same apparent misinformation that was provided to John Boddie was also provided to General Driessnack, see Tab 4.

The chronology of events related to the foregoing is:

(1) March 12, 1982. Mr. Hill's letter to Mr. Spanton stating rotation date of March 1983 and asking for Mr. Spanton's statement of preferences.

(2) March 13, 1982. Mr. Spanton issued his audit report on the high rates of labor cost escalation at Pratt & Whitney, with the inference that such high labor cost escalation rates are general among Defense Contractors. We know the report did not sit well with his superiors because they caused a more timidly worded presentation of the same basic facts to be substituted on April 14.

(3) March 15, 1982. Discussions between Mr. Brown and Mr. Spanton. Mr. Brown's notes state Mr. Spanton's rotation date as March 1983 and do not indicate in any way that an earlier move is contemplated.

Subsequent to the above:

(1) Mr. Spanton responded on 13 April 1982 to Mr. Hill's letter of 12 March. Mr. Spanton listed in preferred order three offices in DCAA's Atlanta Region for reassignment, but also requested a nine-month extension in place from March 1983 to December 1983, and expressed his intent to retire late in 1983 (Tab 5).

(2) On 11 May 1982, Mr. Brown's letter to Mr. Spanton (Tab 2) took note of Mr. Spanton's wish to extend his tenure temporarily at Pratt & Whitney, denied it, and announced a decision to transfer him to California, or elsewhere outside the Atlanta Region no later than 15 September 1982, with the further proviso that Mr. Spanton's "... failure to relocate by that date will be grounds for possible disciplinary action including removal."

The second and third points as related by Mr. Brown (Tab 1) to John Boddie clearly do not justify forcing an unanticipated early transfer on Mr. Spanton, which seems to leave only the matter of the issues raised by Mr. Spanton in his original report on labor rates. With respect to that report, DCAA's Atlanta Regional Director in a 16 July letter to the Director of DCAA has now commended it as "... a good effort on the field office's part." (Tab 6).

Given the record to date, it seems to me at least to imply that there may be a "gentleman's agreement" afoot to encourage or promote an earlier than voluntarily intended retirement by Mr. Spanton. Accordingly, if Mr. Spanton is transferred prematurely or is dismissed, I believe that the adumbrative message that will be clearly conveyed to DCAA auditors will be entirely negative.

Colin D Parfitt

COLIN D. PARFITT

ENCLOSURE 4

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON, D.C. 20330

DIST: SAFFM
SAFFMA
SAFFMB
SAFFMD
SAFFME
SAFFMM
SAFFMP

5 NOV 1983

REPLY TO ATTN OF: RDC

SUBJECT: Collective Bargaining Trends for Period: 1 Jul 83 - 30 Sep 83

TO: ALMAJCOM/Contracting

1. The attached report on collective bargaining agreements negotiated during the period 1 Jul 83 - 30 Sep 83 by contractors of significant importance to the Air Force was prepared by the HQ USAF Industrial Labor Affairs Office. This represents the third such quarterly report, which is being provided to all major Air Force Commands in the hope that it will provide additive information that will be useful in the formulation of Government contract pricing strategies and the negotiation of Forward Pricing Rate Agreements, where applicable. Please insure that this important data is disseminated to all buying activities and personnel within your Command who have need for this type of information. Note that this report is "FOR OFFICIAL USE ONLY" and that its contents should not be disclosed outside the Air Force.

2. The Air Force's main intent in these endeavors is to obtain fair and reasonable prices for goods and services acquired. In accordance with DAR 12-101.1, our position is one of neutrality in all labor-management deliberations. Any questions relating to this data may be referred to my Special Assistant for Labor Affairs, Mr. W. Doyle Williams, Autovon: 227-1879.

FOR THE CHIEF OF STAFF

Bernard L Weiss

BERNARD L. WEISS
Maj General, USAF
Director, Contracting &
Manufacturing Policy

1 Atch
Collective Bargaining Trends Report:
1 Jul 83 - 30 Sep 83 (FOUO)

Cy to: AF/RD
AF/CVA
SAF/AL (Dr. Cooper)
SAF/ALP (Mr. Williams)
SAF/FM (Mr. Hale)

Looks good!
RDH

COLLECTIVE BARGAINING TRENDS REPORT (1 Jul 83 - 30 Sep 83)
Prepared by HQ USAF/RDC-LA

Table 1 summarizes the principal settlement terms of the collective bargaining agreements negotiated during the period 1 Jul 83 - 30 Sep 83 by contractors of significant importance to the Air Force, as monitored by the HQ USAF Industrial Labor Affairs Office. The average first-year general wage increase provided for under these new labor pacts was approximately 3.8%, while the average pre-settlement hourly wage was $9.88. (It should be noted that these figures are simple averages, rather than worker weighted.)

Table 2 compares these third quarter 1983 figures with the average first-year general wage increases and average pre-settlement hourly wages which were previously reported by this office for the first and second quarters of 1983. For the calendar year to date (i.e. the first three quarters of 1983 combined), the average first-year general wage increase provided for in contractor collective bargaining agreements monitored by the HQ USAF Industrial Labor Affairs Office was approximately 3.8%, while the average pre-settlement hourly wage was $9.77.

FOR OFFICIAL USE ONLY

SIGNIFICANT AIR FORCE INDUSTRIAL LABOR SETTLEMENTS[1]
DURING PERIOD: 1 JUL 83 - 30 SEP 83

CONTRACTOR/LOCATION	UNION	PRODUCT(s)	SETTLEMENT DATE	NEW EXPIRATION DATE	PRE-SETTLEMENT AVERAGE HOURLY WAGE	GENERAL WAGE INCREASE(GWI)	COST-OF-LIVING ADJUSTMENT (COLA)	FRINGE BENEFITS
Alloytek Grandville MI	UAW	Jet engine parts	12 Sep 83	7 Sep 86	$10.40	1% - 1st year 1.5% - 2nd year 2% - 3rd year	Previous COLA formula retained	Improved pension benefits.
American Telephone and Telegraph Company Nationwide	CWA	Telecommunication service	28 Aug 83	9 Aug 86	$13.42 - Craft workers $9.32 - Operators	5.5% - 1st year 1.5% - 2nd year 1.5% - 3rd year	Previous COLA formula retained for 2nd and 3rd years only	Improved job security provisions.
Bendix Corporation Communications Division Baltimore MD	IAM	Electronic equipment	31 Aug 83	29 Aug 86	Not available	3.5% - 1st year 3.5% - 2nd year 3.25% - 3rd year	Previous COLA formula retained	Improved pension benefits.
Cameron Iron Works Houston TX	IAM	Turbine cases for jet engines	7 Aug 83	10 Aug 86	$11.14	10% reduction - 1st year 10% restored - 2nd year	3rd year: 1¢ for each .4 increase in CPI, capped at 15¢ per quarter	Holidays reduced from 11 to 10 per year.
E-Systems, Inc. Greenville TX	UAW	Aircraft digital communications systems	7 Aug 83	8 Aug 86	$ 9.06	5% - 1st year 4% - 2nd year 4% - 3rd year	COLA negotiated out	Improved pension benefits.
Emerson Electric Co. St Louis MO	IUE	B-52 defensive fire control; F-5 radar systems	31 Jul 83	3 Aug 86	$ 8.26	5% - 1st year 4% - 2nd year 4% - 3rd year	None	No significant change.
Hayes International Corporation Birmingham AL	UAW	C-130/KC-135 PDM	16 Jul 83	14 Jul 86	$ 9.25	3.2% - 1st year 2.6% - 2nd year 2.5% - 3rd year	Improved to 1¢ for each .4 increase in CPI (formerly 1¢ for each .45 increase in CPI)	Improved pension and insurance benefits.

TABLE 1

FOR OFFICIAL USE ONLY

SIGNIFICANT AIR FORCE INDUSTRIAL LABOR SETTLEMENTS
DURING PERIOD: 1 JUL 83 - 30 SEP 83

CONTRACTOR/LOCATION	UNION	PRODUCT(s)	SETTLEMENT DATE	NEW EXPIRATION DATE	PRE-SETTLEMENT AVERAGE HOURLY WAGE	GENERAL WAGE INCREASE(GWI)	COST-OF-LIVING ADJUSTMENT (COLA)	FRINGE BENEFITS
ITT, Aerospace Optical Division Fort Wayne IN	IUE	Ground radar systems; A/C radio test sets	26 Aug 83	28 Aug 86	$ 8.38	5% - 1st year 5% - 2nd year 5% - 3rd year	None	No significant change.
Kelsey Hayes Company Heintz Division Philadelphia PA	UAW	Jet engine components	10 Sep 83	14 Sep 84	$12.50	One-year extension with no wage increase	Previous COLA formula not operative during one-year extension	No change.
New Hampshire Ball Bearing, Inc. Astro Division Laconia NH	USA	Aircraft engine bearings	14 Sep 83	13 Sep 86	$ 6.81	7.3% - 1st year 6.5% - 2nd year 6.6% - 3rd year	None	No significant change.
Northrup Worldwide Services, Inc. Vance AFB OK	IAM	Base O&M	9 Jul 83	9 Jul 86	$ 8.50	4% - 1st year 6% - 2nd year 8% - 3rd year	None	Improved vacation and dental benefits
Raytheon Company 12 Plants in Massachusetts	IBEW	Radar, communications, and detection systems	27 Aug 83	31 Aug 85	$ 9.06	8% - 1st year 7% - 2nd year	None	Improved vacation, dental, and pension benefits.
Raytheon Company Missile Systems Division Oxnard CA	IBEW	AMRAAM telemetry; missile hardware	30 Sep 83	30 Sep 85	Not available	No across-the-board GWI given, but average wage increase will be approximately 6% annually	None	Improved health, dental, and pension benefits.
RCA International Service Company Patrick AFB FL	IBEW IAM IATSE	AFETR O&M (technical subcontractor)	2 Sep 83	31 Aug 86	$11.41 $11.45 $ 9.23	5%+1% bonus - 1st year 4% - 2nd year 4% - 3rd year	None	No significant change.

[1] Includes data gathered from secondary sources. Caution should be used in regarding these figures as other than an indicator of general trends.

1983 COLLECTIVE BARGAINING TRENDS FOR SIGNIFICANT AIR FORCE CONTRACTORS

TIME PERIOD OF SETTLEMENTS MONITORED	AVERAGE FIRST-YEAR GENERAL WAGE INCREASE	AVERAGE PRE-SETTLEMENT HOURLY WAGE
FIRST QUARTER - 1983	5.0%	$9.73
SECOND QUARTER - 1983	2.4%	$9.70
THIRD QUARTER - 1983	3.8%	$9.88
1983 TO DATE (FIRST THREE QUARTERS COMBINED)	3.8%	$9.77

TABLE 2

DEPARTMENT OF THE AIR FORCE
DIRECTORATE OF BUDGET
BUDGET MANAGEMENT DIVISION

COPIES TO SAFFM
SAFFMA
SAFFMB
SAFFME
SAFFMM
SAFFMP

14 NOV 1983

RANDUM FOR AF/ACB
AF/AC
SAF/FM

BJECT: Negotiated Wage Settlements

call the note I sent in September (attached).
have just learned that our Las Vegas friends
st completed negotiations with Hughes
rcraft Corp (HAC) and achieved a 4.2% negotiated
ge increase versus the Hughes request of
5%.

Nethery
J. NETHERY
, Budget Management Div
torate of Budget

DIRECTORATE OF BUDGET
BUDGET MANAGEMENT DIVISION

26 Sep 83

MEMORANDUM FOR AF/AC
SAF/FM

SUBJECT: Negotiated Wage Settlements

1. I thought you might be interested in the attached information on efforts to control contractor wages as Secretary Orr asked in his 15 April 1982 memo.

2. Lt Col Jon Morris, AF/ACBM, sent a copy of the 15 April letter last year to Maj Bob Jones who saw to it that those guidelines were used in contract negotiations. The result is that the Air Force negotiated a 5% increase while another government agency will pay the same contractor 7%.

3. Although this related to a classified project which would preclude any publicity, it points out what can be done with the right emphasis and sharp people like Lt Col Morris and Maj Jones.

John Nethery
JOHN J. NETHERY
Chief, Budget Management Div
Directorate of Budget

FROM: DET 3 /AC / 3607

TO: ① HQ USAF/XOXP (PASS TO JON Morris/AOBM) 3797

5-1112

SPECIAL INSTRUCTIONS/TEXT:

Jon:

- Ref your telecon this date.
- During the recent EG+G negotiations, we used this letter as strong justification to keep the cost of living and merit pay increases to a minimum for the contractor.
- The bottomline increase (negotiated) was 5%. This was based on two elements: 1) Biannual fogie increases for GS employees (i.e. step increases) amount to about 1.7% per year. 2) Actual pay increase for FY84 of about 3.3%, thus the total 5%.
- EG+G was asking for 7% because recent negotiated increases for personnel who work for DOE was granted at 7%. To say the least, we had a tough time getting them to come down to 5% because they claim that the EG+G people who work out here have a tendency to jump across to DOE (EG+G contract also). Had it NOT been for the DOE 7% figure, I believe we could have come down closer to 4-4.5%.

AUTHORIZED MESSAGE RELEASER SIGNATURE: Robert Jones

NUMBER OF PAGES (EXCLUDING COVER FORM): 1

ACKNOWLEDGEMENT REQUESTED: YES___ NO X

DEPARTMENT OF THE AIR FORCE
WASHINGTON DC 20330

SECRETARY

April 15, 1982

MEMORANDUM FOR MR. HALE, SAF/FM

When the President's Budget is submitted to Congress there is a 5% cost-of-iving raise for civilian personnel and 2% for military.

Under current budget discussions, there is much conversation about reducing ne or the other, or both, of these percentage amounts. In addition, there is a reat deal of discussion about placing some sort of a lid on cost-of-living increases n various entitlement programs such as social security and military retirement.

As we approach our weapon systems, we often encounter contracts which rovide for us to pay increased costs due to wage settlements which the contractor made with his labor force.

I think it is absolutely ludicrous to expect all elements of government and all etirees and pensioners from government to undergo strict limitation of their eceipts from our Federal Government while at the same time, through our ontracts, we pay substantially larger increases to labor forces building our weapon ystems.

Please make every effort to see that we do not pay negotiated wage ettlements to our weapon producers which are greater than the amounts which the ederal Government decides are adequate for its own employees and recipients.

This may involve insisting that some contractors take the excess negotiated ayments out of their profits. It could even involve a case where there are work toppages.

I am fully prepared to accept work stoppages in some of our weapon cquisition programs, if that is what it takes to bring inflation under control and to ring wage settlements down to the level which the Federal Government deems dequate for its own people.

Will you see that this policy is distributed widely to the civilian and military embers who negotiate with our contractors. It should be made available to the ontractors *before* they complete labor negotiations and not after.

Verne

Verne Orr

3153/ 1

Average Pay Raise Fell To 2.6% for First Year Of Major '83 Contracts

By a WALL STREET JOURNAL *Staff Reporter*

WASHINGTON—Average pay raises fell to a record-low 2.6% for the first year of major labor contracts settled last year, reflecting a combination of pay cuts, wage freezes and low pay boosts.

The Labor Department said that over the life of the contracts, the agreements produced annual average-wage boosts of 2.8%, also the lowest increase since the department began issuing such reports in 1968. The previous lows were posted last year, when wage concessions negotiated in 1982 pacts yielded a pay raise of 3.8% the first year, and 3.6% a year over the life of the contract.

The 1983 agreements replaced contracts that called for an average first-year pay boost of 9.3%, and an increase of 6.8% a year over the life of the agreement.

The 2.6% average reflects the fact that while 1.9 million of the approximately three million workers covered by the agreements received an average 5.8% first-year pay increase, about 720,000 workers will receive a pay cut or a freeze. Another 460,000 workers will take pay cuts averaging 6.7% in the first year of the contract. Although subsequent pay increases will fully restore these cuts for some workers, about 395,000 workers will have wages reduced an average of 1.7% a year over the life of the contract.

Contracts providing a first-year increase were bargained in the telephone, airline, aerospace, glass, paper and electrical-product industries. Settlements without a specified wage change were framed in the aluminum, agricultural-implement and metal-container industries. Workers in the steel, transportation and construction industries agreed to wage cuts in at least the first year of the contract.

About half of the workers covered by the 1983 labor agreements will receive annual cost-of-living adjustments. The department's calculations don't include estimates of these. In pacts with such inflation adjustments, first-year pay increases, excluding adjustment, average 2% compared with increases of 3.3% in those without them. The average annual increase over the life of contracts with cost-of-living adjustments was 2% compard with a 3.8% boost for those without the adjustments.

The department's statistics cover major collective-bargaining agreements for companies with 1,000 workers or more in private, non-farm industry.

ENCLOSURE 5

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301

COMPTROLLER

18 MAR 1983

MEMORANDUM FOR ASSISTANT TO SECRETARY OF DEFENSE (R&O)

SUBJECT: Alleged Discrepancies in Contractor's Timekeeping Practices

Your memorandum of December 16, 1982 asked that the Assistant Secretary of Defense (Comptroller) arrange to have the Defense Contract Audit Agency (DCAA) make a special review of timekeeping practices of the Hughes Aircraft Co., Tucson, Arizona. The request was made because of observations by a Government employee of what appeared to be irregularities in the completion of timecards at that location.

The Director, DCAA has advised in the enclosed memorandum of February 22, 1983 that the review has been completed, but that no evidence of manipulation of timecards was found, and that the risk for labor charging irregularities in the departments selected for review appeared to be minimal. A copy of the auditor's report providing more details is also enclosed.

Enclosure
As stated

JOSEPH T. KAMMERER
Deputy Assistant Secretary
of Defense (Cost & Audit)

DEPARTMENT OF DEFENSE
UNITED STATES OF AMERICA

DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VIRGINIA 22314

IN REPLY REFER TO

22 FEB 1983

00
703.4

MEMORANDUM FOR DEPUTY ASSISTANT SECRETARY OF DEFENSE (COST AND AUDIT)

SUBJECT: Discrepancies in Contractor's Timekeeping Practices

We have reviewed the timekeeping practices of Hughes Aircraft Company, Tucson, Arizona, in response to ASD (Comptroller) memorandum dated 10 January 1983. Our review was prompted by ATSD (R&O) memorandum dated 16 December 1982 to the ASD (Comptroller).

Our review encompassed six departments that resembled the descriptions of the departments where the alleged discrepancies in certain timekeeping practices were observed. The review disclosed that Hughes employees were properly completing their timecards. Additionally, we found no evidence that supervisors were manipulating direct labor charges to Government contracts. Enclosed is a memorandum dated 2 February 1983 which summarizes the scope of the review and audit conclusions.

Although internal control weaknesses were not found, we appreciate this matter being brought to our attention.

C. O. STARRETT, Jr.
Director

Encl ENCLOSURE TO BE CONSIDERED
"FOR OFFICIAL USE ONLY"

DEFENSE CONTRACT AUDIT AGENCY
SAN FRANCISCO REGION
450 GOLDEN GATE AVENUE
BOX 36116
SAN FRANCISCO, CALIFORNIA 94102

IN REPLY REFER TO
RSO-7 702.3

2 February 1983

MEMORANDUM FOR MR. ARTHUR GRISHAM, REGIONAL AUDIT MANAGER

THRU MR. WILLIAM SERAFINE, CHIEF OPERATIONS AUDIT TEAM

SUBJECT: Risk Assessment of Potential Labor Charging Irregularities at Hughes Aircraft Company, Tucson Division

In response to your 28 January 1983 request, I have summarized the results of our review of potential labor charging irregularities at Hughes-Tucson.

The purpose of the review was to perform a risk assessment of potential labor charging irregularities observed during a recent tour of the Hughes Aircraft Company, Tucson Division, by members of a DOD group. During the subject tour, there were observations of what appeared to be some labor charging irregularities involving supervisory personnel filling out timecards for their employees. These observations were apparently made at two separate locations in the Hughes-Tucson plant. The specific departments involved were not identified. However, one location was described as a circuit card process. Using this limited information and other data obtained from Government personnel who were involved in the tour, we were able to narrow the scope of our risk analysis to the following six process departments in the manufacturing area.

Departments Selected for Review

Dept. No.	Description	No. of Employees
55-5571	Spot Welding	4
55-5572	Painting	8
55-5573	Plastics	9
55-5581	Etched Circuiting	44
55-5582	Heat Treatment	3
55-5583	Plating & Deburring	20
		88

Our review of the six selected process areas included:

1. Review of the Hughes-Tucson Division's timekeeping and labor recording policies and procedures.

2. Perambulations and observations in the selected process areas.

3. Review of the Hughes-Tucson Division's labor allocation and distribution system.

4. Analysis of the workorder scheduling and contract assignment system.

5. Analysis of the multicontract workorder labor allocation procedure.

6. Review of employee timecards. [illegible]

7. Interviews and floorchecks of employees and supervisors.

8. Coordination with the resident Air Force Plant Representative Office (AFPRO).

Our review disclosed no audit evidence that supervisors are filling out timecards for employees. Moreover, we found that Hughes-Tucson's timekeeping and labor recording practices in the areas selected for audit are generally adequate. Perambulations and observations showed that employees generally have their timecards on their persons or at their workstations, and were filling out their own timecards. Further, interviews of employees and supervisors did not disclose any indication of supervisory manipulation of labor charges at the timecard level.

Employees in the selected process areas utilize daily timecards, and will generally charge from two to twenty workorders a day. Thus, supervisory manipulation of timecharges would require a substantial number of daily changes. Also, review of timecards for August 1982 through January 1983 did not disclose a significant number of charge number alterations (i.e., whiteouts, erasures, scrape offs, etc.) or indications of similar hardwriting on different employee timecards.

Workorders which are used as the basis for labor recording are, for all programs except TOW, the output of a Material Requirements Planning (MRP) system. The MRP system is a computer program which takes contract requirements, workorder status reports, and item deliveries, and other production data and issues workorders to the various production areas. The workorders issued by the MRP system can include parts for one or more contracts. Labor and production materials charged to a workorder are allocated to the various contracts based on a ratio of contract parts to total workorder parts. Contractual data and labor and material allocation ratios are not part of the workorder which accompanies parts to production areas. Thus, manipulation of workorder charges at the recording level would require that production obtain contract information from outside sources.

During our review we did identify a circuit card process which had labor recording attributes similar to those observed in the DOD tour. The process involved dipping printed circuit boards in a series of chemical baths. There are three employees on this line: a loader, a monitor and an unloader. The loader starts the process by putting the circuit cards to be processed on a holding rack. The rack is moved thru the chemical baths by a numerically controlled machine. During the chemical processing the monitor will follow the boards to make sure they are properly aligned and do not become displaced during the run. At the completion of chemical processing the unloader removes the boards from the holding rack and places them in holding bins for further processing. Because this is a continuous process, the employees have developed a system where the loader enters the workorder number on all three timecards as the lots are processed. This employee is not a supervisor and he does not enter times, just the workorder numbers. Without this type of system, the process would have to be stopped after each workorder so that the monitor and unloader could go to the head of the line to obtain the workorder number. Obviously, this would not be economical practice.

In summary, it is our opinion that the risk for labor charging irregularities in the six selected process areas is minimal. Further, we found no audit evidence to show that supervisors are filling out timecards for their employees or manipulating labor charges to the detriment of the Government. We feel that the highest potential risk for labor mischarges would be manipulation of inputs to the MRP system, and labor transfers subsequent to timecard recording. Audit leadsheets have been provided to the FAO on these and other potential risk areas identified during our review.

NORMAN E. WARNER
Senior Auditor

Chron

15 DEC 1982

(Review and Oversight)

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)

SUBJECT: Discrepancies in Contractor's Timekeeping Practices

In the course of our DoD contract audit oversight, we were informed of recent observed discrepancies in internal controls over timekeeping practices and the possible mischarging of direct labor costs at a DoD contractor's plant. The discrepancy was observed recently at two separate locations in the Hughes Aircraft Company plant in Tucson, Arizona.

In both observations, section supervisors were seen completing the labor job cards for all the employees under their direction, instead of the employees filling out their own cards. Although the exact location of the obserations were not identified, one was in a section involved in the process of dipping printed circuit boards in molten lead to accomplish the soldering function and was adjacent to a section where multiple holes were being gang drilled into circuit boards.

Depending on the materiality of these discrepancies, the company's labor accounting practices could result in arbitrary allocations of labor costs and could be conducive to potentially fraudulent labor charging on government contracts. Accordingly, it is requested that the Defense Contract Audit Agency (DCAA) conduct an audit of Hughes Aircraft Company labor accounting practices at the Tucson, Arizona plant with the objective of determining whether the recent observed discrepancies in labor accounting practices presently exist; and, if so, (i) the nature and extent of the improper practices (including an opinion regarding how long such practices have been in force), and (ii) the approximate monetary impact on government contracts.

I would appreciate your advising the Director, DCAA to report the initiation and the results of this audit to Mr. Charles D. Woehrle, Acting Assistant Inspector General for Audit Oversight and Policy, Room 1272, Commonwealth Building, 1300 Wilson Boulevard, Arlington, Virginia 22209. Due to the possible implication of the observations, I suggest that this audit be given immediate attention.

SIGNED

Joseph H. Sherick
Assistant to the Secretary of Defense
(Review and Oversight)

OAIG AOP/MXXX/CCipolla/mlm/12-8-82
jdd/12-15/82
Subject RF Chron R&O
cy to: DCAA, Acting AIG-INV, ASAF(SAF/FM) Management Systems 4E975

MEMORANDUM AUDIT REPORT ON SPECIAL REVIEW OF TIMEKEEPING PRACTICES IN THE PROCESS SHOP AREAS

HUGHES AIRCRAFT COMPANY
TUCSON, ARIZONA

The Defense Contract Audit Agency has no objection to the release of this report at the discretion of the Contracting Officer to the duly authorized representatives of Hughes Aircraft Company.

Under the provisions of Title 32, Code of Federal Regulations, Part 290.26(b)(2) (as amended August 10, 1977), all Freedom of Information Act requests for audit reports received by DCAA will be referred to the cognizant contracting officer for determination as to releasability and a direct response to the requestor.

Contractor information contained in this audit report may be confidential. The restrictions of 18 USC 1905 should be considered before this information is released to the public.

This report may not be released to any Federal agency outside the Department of Defense without the approval of Headquarters, DCAA, except to an agency requesting the report in negotiating or administering its contract.

DEFENSE CONTRACT AUDIT AGENCY
SAN FRANCISCO REGION
RESIDENT OFFICE
HUGHES AIRCRAFT COMPANY
TUCSON, ARIZONA

AUDIT REPORT NO. 3A130104-001

DATE OF REPORT: 30 June 1983

DEFENSE CONTRACT AUDIT AGENCY
SAN FRANCISCO REGION
Resident Office
Hughes Aircraft Company
P. O. Box 11337, Bldg 801, M/S F4
Tucson, Arizona 85734

IN REPLY REFER TO
3A130104
(0146)

30 June 1983

SUBJECT: Memorandum Audit Report on Special Review of
Timekeeping Practices in the
Process Shop Areas
Hughes Aircraft Company (HAC)
Tucson, Arizona
Audit Report No. 7471-3A130104-001

1. Purpose and Scope of Audit.

a. As coordinated with Ed Stranere of Headquarters, a review was made of the reported internal control weaknesses contained in a memorandum from Mr. Joseph H. Sherick, Assistant to the Secretary of Defense (Review and Oversight), dated 16 December 1982, same subject, to the Assistant Secretary of Defense (Comptroller). The purpose of the review was to perform a risk assessment of potential labor charging irregularities observed during a recent tour of the Hughes Aircraft Company, Tucson Division, by members of a DoD group.

b. The evaluation was performed in accordance with generally accepted auditing standards and included such tests of HAC's data and records and such other auditing procedures we considered necessary in the circumstances. Our review of the selected process areas included:

1. Review of the Hughes-Tucson Division's timekeeping and labor recording policies and procedures.

2. Perambulations and observations in the selected process areas.

3. Review of the Hughes-Tucson Division's labor allocation and distribution system.

4. Analysis of the workorder scheduling and contract assignment system.

5. Analysis of the multicontract workorder labor allocation procedures.

6. Review of employee timecards.

7. Interviews and floorchecks of employees and supervisors.

8. Coordination with the Resident Air Force Plant Representative Office (AFPRO).

2. Results of Audit.

a. We selected six departments that matched the descriptions where the observed discrepancies occurred. Our review disclosed no audit evidence that supervisors are filling out timecards for employees. Moreover, we found that Hughes-Tucson's timekeeping and labor recording practices in the areas selected for audit are generally adequate. Perambulations and observations showed that employees generally have their timecards on their persons or at their workstations, and were filling out their own timecards. Further, interviews of employees and supervisors did not disclose any indication of supervisory manipulation of labor charges at the timecard level.

b. During our review we did identify a circuit card process which had labor recording attributes similar to those observed in the DOD tour. The process involved dipping printed circuit boards in a series of chemical baths. There are three employees on this line: a loader, a monitor, and an unloader. The loader starts the process by putting the circuit cards to be processed on a holding rack. The rack is moved thru the chemical baths by a numerically controlled machine. During the chemical processing the motor will follow the boards to make sure they are properly aligned and do not become displaced during the run. At the completion of chemical processing the unloader removes the boards from the holding rack and places them in holding bins for further processing. Because this is a continuous process, the employees have developed a system where the loader enters the workorder number on all three timecards as the lots are processed. This employee is not a supervisor and he does not enter times, just the workorder numbers. Without this type of system, the process would have to be stopped after each workorder so that the monitor and unloader could go to the head of the line to obtain the workorder number. Obviously, this would not be economical practice.

c. Although the reported internal control weaknesses were not found to exist, we did develop from this audit a series (8) of audit leadsheets to be reviewed during our upcoming comprehensive labor audit.

3. Concluding Remarks.

a. Copies of the above noted audit leadsheets have been put in the file for follow-up during our comprehensive labor audit.

b. This report should not be used for purposes other than that immediately intended without prior consultation with this office regarding its applicability-

DEFENSE CONTRACT AUDIT AGENCY

Original Signed By
CARL R. GRUNDY
CARL R. GRUNDY
Resident Auditor

ENCLOSURE 6

DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VIRGINIA 22314

IN REPLY REFER TO

7 JAN 1983

OTD
703.4.63

MEMORANDUM FOR ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT)
DEPUTY FOR ACQUISITION, OFFICE OF THE ASSISTANT SECRETARY
OF THE AIR FORCE (RESEARCH, DEVELOPMENT, AND LOGISTICS)

SUBJECT: Interim Report on DCAA Survey of Labor Costs

I. Background

On 24 August 1982, the Assistant Secretary of the Air Force (Financial Management) requested that DCAA perform a survey of compensation rates. DCAA was asked to meet with the representatives of Air Force Acquisition and Financial Management Offices to definitize the scope, objectives and parameters of the survey. Subsequent meetings were held with the AF representatives to discuss their concerns about the increasing compensation rates within the aerospace industry. There was agreement between the Air Force and DCAA representatives that all interested parties in DoD and the Air Force would attempt to use the same data to focus the survey and avoid overtaxing DCAA/contractor resources with voluminous, uncoordinated requests. For the same reasons, the survey would be done in a series of steps. This also permits expansion of the survey into new directions based on findings in earlier steps of the review.

On 21 September 1982, we presented to the AF representatives our plan for performing a survey of labor costs by means of a number of interim steps or milestones with each designed to address a major segment of the total compensation package. This plan would allow for interim progress reports, and the concluding summary of all the steps would constitute the desired comprehensive survey. The plan was endorsed by the AF representatives. A copy of the plan is shown as Enclosure 1.

The initial step in the plan provided for determining increases experienced in cost of living adjustment (COLA), general wage increase (GWI), and merit pay for use in analyzing labor and fringe costs. (GWI represents compensation changes for hourly employees to maintain pay rates that are competitive with the job markets and to recognize productivity increases. Similarly, merit increases are given to salaried employees for productivity improvements and to keep their pay rates competitive with the job market.) AF representatives provided the list of contractor locations that would be included in the survey. Adhering to the tight time schedule established by the study representatives, we issued, on 8 October 1982, a survey form to selected DCAA offices requesting that they provide information on COLA, GWI, merit pay and other related data for 1978 through 1981. With regard to this data, the survey form requested the:

8300228

BLS 372

7 JAN 1983

OTD
SUBJECT: Interim Report on DCAA Survey of Labor Costs

(1) Percentage increase by labor category.

(2) Percentage increase for all direct employees.

(3) Total company composite direct labor rate.

(4) Total fringe benefit costs.

(5) Total direct and indirect labor dollars.

(6) Total headcount and union percent.

(7) Company sales/costs.

We received 61 completed survey forms. Some offices submitted the data on separate divisions of the contractor's operations at their locations. The 61 responses received were identified by the contractor's Standard Industrial Classification (SIC) code. The SIC system is used by many Government agencies. The Census of Manufacturers has identified 450 manufacturing industries. The system is designed so that the definitions of the industry become progressively narrower with successive additions of numerical digits. There are 20 very broad 2-digit major industries, 150 3-digit industries and 450 4-digit industries. Thus, SIC code 372 is a relatively broad industry grouping comprised of several 4-digit groups. Using the SIC codes, we grouped the responses as follows:

SIC Code	# of Responses
366-Communication Equipment	13
372-Aircraft and Parts	32
Miscellaneous Codes	16
Total	61

The survey questionnaire asked for historical information on the percentage of increases given for COLA, GWI, and merit to both hourly and salaried employees by specific labor category. This specific information was not always available in contractors' records or identified separately as COLA, GWI, or merit increases. Further, many of the companies had labor functions that did not fit in the limited labor categories identified in the survey questionnaire. Therefore the responses to these questions did not provide us with statistics that we could use as a sound basis for analyzing increases in employee compensation for selected categories of labor.

7 JAN 1983

OTD
SUBJECT: Interim Report on DCAA Survey of Labor Costs

For these reasons, we analyzed the data on a companywide basis using weighted composite direct labor rates, including all hourly and salaried engineering, manufacturing, and other direct labor. We believe that the trend data and comparisons made using weighted composite direct labor rates gives us useful study information. It provides a consistent and uniform base, reflecting actual charges to defense contracts over the entire survey period. 10%

II. Analyses

The bar chart (Enclosure 2) illustrates the total direct labor compensation rate by the two predominant SIC codes (communication equipment and aircraft and parts) and the total for all 61 contractors for each year. The total compensation rate (fringe benefits and payroll cost) has increased from $12.77 an hour in 1978 to $16.87 an hour in 1981 for the 61 contractors surveyed. The rate information for Communication Equipment and Aircraft and Parts showed little variation from the overall statistics. Rate growth trends by the major SIC codes did not vary appreciably from the statistics for all of the contractors in the survey.

Enclosure 3 demonstrates a cumulative comparison in percentage increases for the Consumer Price Index (CPI), direct labor payroll cost and fringe benefits. The direct labor rates and fringe benefit costs showed a 32 percent increase for the period compared to a 39.5 percent increase in the CPI for the same period. Although fringe benefit costs have increased at approximately the same rate as direct labor from 1978 to 1981, the fringe costs increased at a greater rate in 1980 and 1981. In 1981, the percent increase on average exceeded the rate of inflation. This trend seems to indicate that fringe costs may be the predominant cause in rising labor compensation costs and should be reviewed in detail in the next phase. By comparison, compensation increased 29.7 percent for all durable goods manufacturers and 29.5 percent for all manufacturing for the comparable period. Based on this analysis, the cumulative increases for labor and fringe rates for the aerospace industry contractors we surveyed are generally in line with the industry indicators for the period. The defense contractors in our survey represent a significant part of the economy's industrial base. Although they may affect some BLS statistics, we do not believe our conclusion is biased because we compared increases to more than one indices. 9%

We performed correlation analysis to determine if a high union workforce percentage or a high percentage of Government sales resulted in higher labor and fringe increases. The correlation percentage was extremely low. The points were so dispersed for the surveyed contractors that we concluded it did not support the premise that a high union workforce percentage or a high percentage of Government sales results in higher labor and fringe costs.

Enclosure 4 shows the responses received on the sixty-one contractor locations for both the average direct labor rates and average annual fringe benefit costs per employee. The percentage increases from 1978 to 1981 have been ranked to illustrate the highest to the lowest increases given.

We have not identified the individual contractors. The information and data provided is considered company proprietary and thus should not be made available to the public or given wide distribution within the Department of Defense. Therefore we will disclose the contractor's identification only to those individuals that you jointly designate as having a "need-to-know" for such information. Contractors should be advised in advance of any proposed release of such data.

Good Dwaine

III. Conclusion

The percentage increases provided by the contractors in our survey on an average companywide basis have not exceeded the rate of inflation as measured by the CPI for the survey period. However the annual percentage growth, particularly for fringe benefit costs, have increased at a growing rate outstripping the CPI in 1981. Our suggested steps for the second phase of the survey should provide further insight on the specific elements of labor and fringe benefit expenses that are keying this accelerated cost growth.

Further analyses of statistics by SIC code, percentage of contractor's union workforce or the contractor's amount of Government business did not show any significant trends or provide any leads that would require special review.

Secretary Hale's memorandum of 24 August 1982 also requested that a comparison be made of the rate of increases in defense industry compensation with the increases given to active and retired Federal employees. We discussed this issue with representatives from Air Force Financial Management and Acquisition Offices. There are a number of variables to be considered in making a valid comparison of such increases between employees in the private sector and the Federal Government. The Financial Management representatives indicated they would address this issue in their analysis using the data in this report.

The responses received, as shown on Enclosure 4 have been ranked to show the wide disparity in the percentage increases by contractor.

7 JAN 1983

OTD
SUBJECT: Interim Report on DCAA Survey of Labor Costs

Because of the substantial difference between the highest and lowest percentage increase, we plan to review the causes under future phases of our survey of total compensation.

This history may well reflect, in part, prior Department of Defense negotiation practices where trend data and inflationary indices were often used as the benchmarks in negotiation of forward pricing rate agreements or recommendations. Such benchmarks generally held negotiated forward pricing rates (and actual compensation) in line and somewhat below the inflationary growth in the CPI for the study period. However, if such practices did not serve to feed inflation, they did not, in all probability, deter it. It is apparent we need to explore other techniques for analyzing and evaluating contractors' compensation projections.

IV. Second Phase of the Survey.

The following are additional steps that we believe should be included in the next phase of the survey on labor compensation:

(1) Obtain the labor rates for hourly and salaried employees by production/manufacturing direct labor and engineering direct labor.

(2) Compare the hourly wage for production workers to national BLS indices.

(3) Compare the hourly wage for production workers to geographic BLS indices.

(4) Determine if fringe costs vary significantly for hourly and salary employees to the point that we can identify a different rate by category of employee.

(5) Analyze fringe cost by element to determine if individual elements are increasing at a disproportionate rate and which fringe elements represent the major dollars of fringe costs. Also determine if any fringe costs are restricted in distribution to selected groups of employees, e.g. executives.

C. O. STARRETT, Jr.
Director

Encls (4)

Overview of Total Compensation
(COLA, GWI, Merit and Fringe)
Study Within Aerospace Industry

1. AF Concerns

a. Recent study indicates aerospace compensation (salary, wage, fringe benefits) rates significantly higher than BLS average manufacturing rates.

b. Projections of inflation are based on past history of high inflation rather than the current projected lower trend.

c. Labor rate increases are based on nationwide rates rather than area wages.

2. DCAA Objective

To determine the actual Cost of Living Allowance (COLA) and General Wage Increase (GWI), merit increase and fringe benefit costs of DoD contractors in the aerospace industry for the last four years.

3. Approach to Accomplish Objective

A survey form will be issued for completion by the DCAA offices cognizant of the contractors listed on Attachment 1.

The survey form will request the actual COLA, GWI, merit, and fringe costs for the last four years categorized by the contractor's major aerospace product line (airframe, missile and space, aircraft engines and parts, other). Where the increase cannot be separated between COLA, GWI and merit, the audit office will provide the combined totals. Obtain the total fringe benefit costs for each contractor. We will request the contractor identify the SIC code they are placed in. Upon receipt of the completed survey forms, we will analyze the data and prepare a summary. After completion of this first step, we will prepare an outline to discuss proposed approaches for further analysis of labor rate increases.

4. Potential Areas for Further Analysis

a. Whether the mix of business (Government/commercial) impacts the wage increases given? Whether the union agreements are negotiated top-down or by locality and if this could impact the agreements?

b. Whether the labor rates exceed the average geographic wage rates? If so, is there a reason for this, such as the job speciality/expertise/location?

Enclosure 1

c. Whether our audit evaluation techniques are properly analyzing wage escalation and recommending current trends and not historic trends?

d. Whether the indices being utilized contain comparable data or whether nonrelated data is also included? Is there a better index?

e. Whether compensation system reviews are being performed or requested? Has auditor/ACO performed any reviews.

f. Whether the DAR cost principle 15-205.6 is too broad and needs more stringent language?

5. Milestones

a.	Discuss the overview with AF	9/21/82
b.	Make any adjustments necessary	9/24/82
c.	Prepare and issue FAO survey questionnaire on COLA and GWI	10/1/82
d.	Receipt of questionnaire responses	11/5/82
e.	Complete analysis of responses	11/19/82
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List of Contractors for Survey

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Ford Aerospace and Conn (Newport Beach, CA)

G/D (Ft. Worth, San Diego and Pomona)

G/E (Evendale, Philadelphia (Space Systems Division Plus Re-Entry System)

West Lynn

GMC Delco Electronics Suboffice, Goleta, CA

Grumman (Bethpage, NY)

Honeywell (Minneapolis)

Hercules (Magna, UT)

Hughes (ElSegundo (Res), Tucson (Res), plus Helicopter, Culver City)

Garrett (Phoenix) (Los Angeles)

Lockheed (Georgia), (LMSC), (California, Burbank) (Palmdale)

Northrop (Hawthorne, CA plus Electromechanical, Anaheim, CA)

McDonnell Douglas (St. Louis), (Long Beach), (Huntington Beach)

Martin Marietta (Denver, Orlando and Baltimore)

Raytheon (Missile Systems, Bedford, MA)

Rockwell (International (LA)), Columbus (International Suboffice)

(Downey, CA), (Anaheim, CA)

Sperry Univac (Suboffice St. Paul) (Sperry, Great Neck, NY)

Thiokol (Suboffice Brigham City, UT)

TI (Richardson, TX)

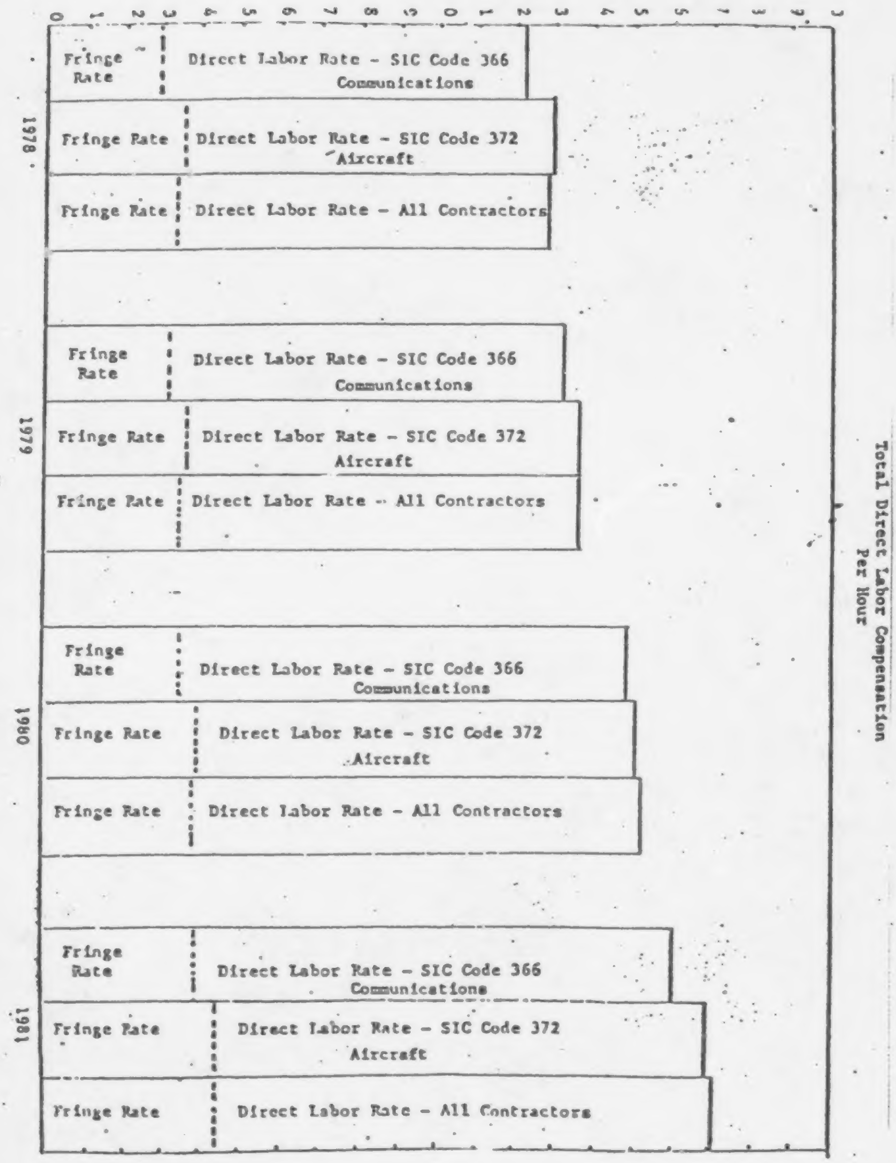
Textron (Res. Bell Helicopter, Ft. Worth)(Bell Aerospace Textron,
Buffalo, NY)

TRW (Redondo Beach)

UTC - (P&W West Palm and East Hartford), Sikorsky, Hamilton Standard
and Chemical System Division

Vought (LTV) Dallas

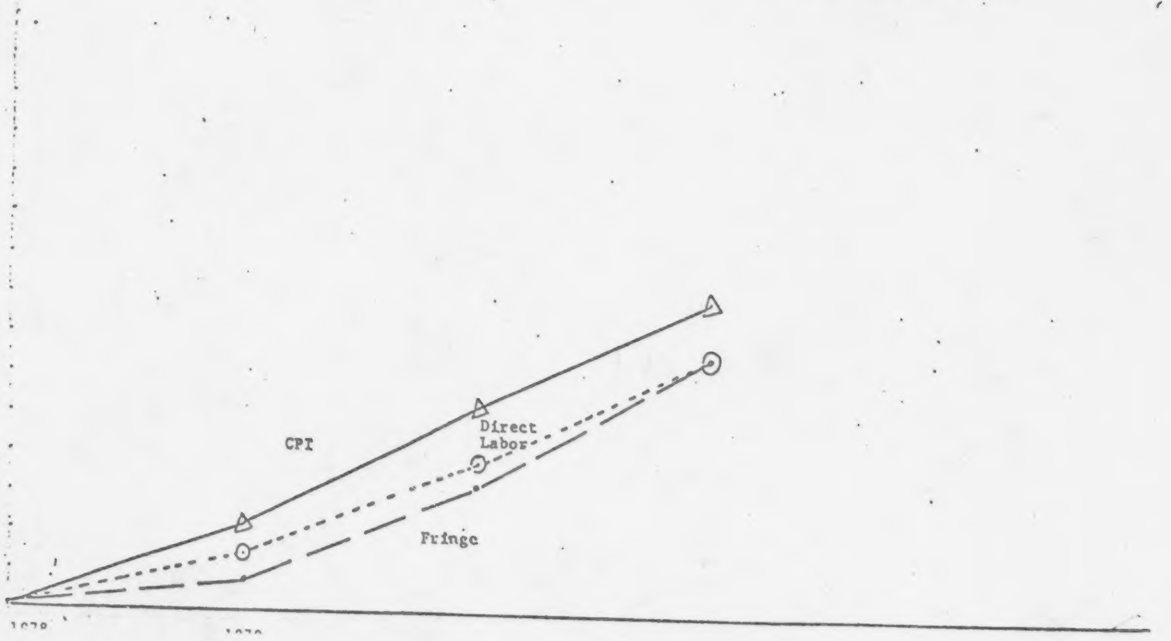
Westinghouse (Baltimore)



1978
Fringe Rate
Direct Labor Rate - SIC Code 366 Communications
Fringe Rate
Direct Labor Rate - SIC Code 372 Aircraft
Fringe Rate
Direct Labor Rate - All Contractors
1979
Fringe Rate
Direct Labor Rate - SIC Code 366 Communications
Fringe Rate
Direct Labor Rate - SIC Code 372 Aircraft
Fringe Rate
Direct Labor Rate - All Contractors
1980
Fringe Rate
Direct Labor Rate - SIC Code 366 Communications
Fringe Rate
Direct Labor Rate - SIC Code 372 Aircraft
Fringe Rate
Direct Labor Rate - All Contractors
1981
Fringe Rate
Direct Labor Rate - SIC Code 366 Communications
Fringe Rate
Direct Labor Rate - SIC Code 372 Aircraft
Fringe Rate
Direct Labor Rate - All Contractors
Total Direct Labor Compensation Per Hour

Comparison of Cumulative
Increase in CPI,
Direct Labor and Fringe

Year	CPI %	CPI Cum.	Direct Labor %	Direct Labor Cum.	Fringe %	Fringe Cum.
1978	Base	-	Base	-	Base	-
1979	11.3	11.3	7.2	7.2	4.0	4.0
1980	13.5	26.3	10.8	18.8	11.7	16.2
1981	10.4	39.5	11.3	32.2	13.5	31.9



CASE NO	1978	1979	1980	1981	% Increase 1981/1978	Rank
1	8.200	8.870	10.140	11.430	39.4	9
2	8.850	9.570	10.550	11.770	33.0	28
3	7.990	8.450	9.170	10.170	27.3	45
4	6.850	7.030	7.840	9.160	33.7	24
5	9.660	10.410	11.120	12.000	24.2	58
6	7.890	8.350	9.230	10.110	28.3	44
7	8.850	9.740	10.510	11.470	29.6	42
8	7.870	8.070	8.660	9.830	24.9	56
9	6.960	7.475	8.546	9.546	37.0	14
10	10.270	10.950	12.050	13.990	36.2	15
11	7.240	7.890	9.030	9.820	35.6	18
12	6.890	7.420	8.280	9.080	31.8	33
13	11.220	11.860	13.150	14.570	29.9	40
14	9.530	10.200	11.830	12.940	35.8	17
15	11.200	12.090	12.000	14.440	28.9	47
16	11.650	11.930	13.110	14.730	26.4	49
17	9.320	9.790	10.750	12.130	30.2	39
18	10.030	10.970	11.780	12.840	28.0	46
19	7.320	7.980	9.110	10.320	41.0	7
20	9.000	10.060	11.340	12.500	38.9	11
21	10.740	11.510	12.630	14.390	34.0	23
22	9.610	10.410	11.560	12.520	30.3	38
23	9.860	10.470	11.240	13.130	33.2	27
24	9.080	9.900	11.250	13.150	44.8	1
25	9.530	10.160	11.110	12.510	31.3	36
26	10.570	11.310	11.940	13.210	25.0	55
27	10.360	11.530	12.390	13.950	34.7	22
28	12.190	13.860	15.160	16.150	32.5	30
29	8.920	9.770	11.320	12.060	35.2	19
30	9.430	9.900	11.020	11.920	26.4	50
31	9.560	10.170	11.090	12.600	31.8	32
32	9.060	9.870	10.910	12.870	42.1	5
33	11.020	11.900	12.040	14.130	28.2	45
34	9.080	9.780	11.130	12.240	34.8	21
35	7.730	8.910	9.330	9.670	25.1	53
36	10.220	10.270	11.260	12.890	26.1	51
37	8.750	8.700	9.400	10.440	19.3	59
38	10.990	12.530	13.930	14.930	35.9	16
39	10.930	11.720	13.010	14.480	32.5	31
40	8.460	9.200	10.430	11.620	37.4	13
41	10.020	10.660	11.510	12.530	25.0	54
42	11.090	12.100	12.780	13.830	24.7	57
43	9.310	9.410	10.070	10.920	17.3	61
44	8.280	8.970	10.630	11.750	41.9	6
45	8.700	9.170	10.210	11.530	32.5	29
46	10.270	11.080	12.430	13.890	35.0	20
47	11.380	12.250	13.520	15.200	33.6	25
48	8.340	9.520	10.780	11.630	39.4	8
49	13.360	14.620	16.410	17.560	31.4	35
50	10.370	11.060	11.670	13.010	25.5	52
51	12.170	13.610	14.270	15.800	29.8	41
52	7.840	8.710	9.990	11.200	42.9	3
53	9.550	10.190	11.420	12.530	31.2	37
54	8.910	9.300	9.900	10.570	18.6	60
55	9.050	10.030	11.770	13.000	43.6	2
56	9.690	10.670	11.490	13.450	38.9	10
57	9.010	9.550	10.660	12.010	33.3	26
58	6.970	7.510	8.570	9.690	38.9	12
59	8.930	9.460	11.020	12.690	42.1	4
60	8.300	8.000	9.650	10.910	31.4	34
61	10.850	11.700	12.780	14.060	29.5	43
Weighted Avg.	9.410	10.090	11.180	12.440		

Enclosure 4
Page 1 of 2

Fringe Costs Per Person
($000)

CASE NO	1978	1979	1980	1981	% Increase 1981/1978	Rank
1	6.360	7.620	9.390	10.000	57.2	10
2	6.970	7.160	8.440	9.400	34.5	29
3	4.900	5.240	6.300	7.530	53.7	11
4	4.900	5.200	6.170	7.980	62.9	8
5	8.290	9.110	10.170	11.170	34.7	28
6	8.450	8.910	10.530	10.550	24.9	50
7	3.690	3.900	4.250	5.180	40.4	22
8	4.230	4.070	4.170	5.130	21.3	54
9	5.710	5.820	6.190	7.670	34.3	30
10	8.070	8.670	10.700	11.900	47.5	15
11	4.920	5.720	5.960	6.840	39.0	24
12	4.650	5.050	5.850	6.700	44.1	18
13	5.500	5.950	7.280	9.410	71.1	5
14	6.600	8.110	9.910	8.820	33.6	32
15	8.440	8.830	9.730	11.090	31.4	37
16	8.750	9.470	12.000	14.660	67.5	6
17	8.710	8.610	9.520	12.600	44.7	16
18	4.290	5.030	5.930	6.580	53.4	13
19	6.970	8.640	9.980	8.960	28.6	42
20	7.270	7.910	8.740	9.530	31.1	33
21	13.440	14.550	10.330	10.900	40.6	21
22	11.630	11.030	11.350	15.310	31.6	35
23	9.050	10.340	11.720	12.820	41.7	20
24	4.950	5.870	7.240	9.430	90.5	1
25	4.580	4.800	5.260	6.310	37.8	26
26	4.970	5.230	5.750	6.330	27.4	44
27	13.460	12.770	13.190	16.310	21.2	55
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32	5.520	4.020	4.890	6.940	25.7	49
33	10.500	8.920	8.750	10.620	1.1	61
34	6.750	7.120	8.490	9.310	37.9	25
35	5.430	6.430	7.210	7.360	35.5	27
36	7.830	8.600	9.640	10.250	30.9	39
37	5.640	5.730	6.170	7.000	24.1	51
38	8.050	9.450	9.660	10.270	27.6	43
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45	4.500	5.710	7.050	8.000	77.8	3
46	8.250	9.070	9.630	11.060	34.1	31
47	8.630	9.760	9.930	10.920	26.5	45
48	7.710	10.370	11.820	13.810	79.1	2
49	5.650	6.780	8.150	7.380	29.9	41
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54	7.710	8.960	8.910	8.710	13.0	58
55	7.230	8.660	9.940	12.400	71.5	4
56	6.640	7.310	8.900	10.200	53.6	12
57	7.950	9.090	10.040	11.860	49.2	14
58	4.150	4.230	5.630	5.790	39.5	23
59	10.670	9.420	9.780	11.920	11.7	59
60	6.820	7.010	7.000	8.120	19.1	55
61	7.610	8.200	9.490	10.100	32.7	33
Weighted Avg.	6.990	7.260	8.120	9.210		
Yearly Rate	3.360	3.490	1.900	4.430		

AcSEC POSITION ON TAX ACT AND DEPRECIABLE LIVES

Economic Recovery Tax Act of 1981 established the Accelerated Cost Recovery System
S), which replaces the depreciation system for income tax purposes. ACRS eliminates for
e taxes the need to select a depreciation method and to determine each asset's useful life
lvage value. Instead of depreciation deductions permitted by prior tax laws, enter-
must now use recovery deductions in determining taxable income. The recovery deductions
ermined by applying percentages specified by the law to the tax basis of the asset for
ied number of years.

Institute's accounting standards executive committee has been asked whether the
deductions used for income tax purposes also may be used as depreciation expense for
reporting.

rally accepted accounting principles require that the cost of depreciable assets be
to expense over the expected useful life of the asset in a systematic and rational
contrast, the recovery deductions required under ACRS were designed to encourage
in productive assets by allowing accelerated deduction of the tax basis of an asset.
umber of years specified by ACRS for recovery deductions for an asset does not fall
sonable range of the asset's useful life, the recovery deductions should not be used as
on expense for financial reporting. Depreciation expense in financial statements
sset should be determined based on the asset's useful life.
overy deductions for income tax purposes differ from depreciation expense for
ting, deferred income taxes should be provided in financial statements for the
ces that result, as required by APB Opinions nos. 1 and 11.

23/81 issue of The CPA Letter

THE UNDER SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

RESEARCH AND
ENGINEERING

LABOR
#13

20 OCT 1982

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Study of Defense Industry Contractor Labor Rates

There is concern from several sources about the reasonableness of DoD contractor labor rates. These sources include the Congress and the general public. Basically, the contentions are that high rates are perpetuated because (1) future rates are projected from an inflated historical data base, and (2) defense contractors are "soft" when negotiating agreements with labor unions because the cost can be passed through to the Department under the existing acquisition policies and procedures. Furthermore, comparisons of labor rates among companies comprising the defense industrial base are misleading because they are all excessively high.

Replies to these charges have been weak at best, and in some cases they have been virtually affirmed as true. It may be possible that the Department is doing a better job than it has been given credit for to date. On the other hand, there are some strong indicators that point towards a situation that may need corrective action. The problem is that right now neither conclusion is supported by empirical data. Therefore, we are establishing a special Ad Hoc Committee to conduct an indepth review to:

1. Determine and articulate what is being done, at this time, within the Department to establish the reasonableness of labor rates.

2. Develop the statistical data, by geographic areas, from contractors, unions, industry associations, Department of Labor, other Government offices, etc., needed to determine whether the present procedures are effective.

3. Develop any necessary recommendations for corrective action.

The need for this Special Study of Defense Industry Contractor Labor Rates has been discussed with Mr. Charles O. Starrett, Jr., Director of DCAA. Mr. Starrett concurs in such a study and advised that DCAA will provide the necessary assistance needed of that Agency. Brigadier General Bernard L. Weiss, DCS/Contracting and Manufacturing, Air Force Systems Command is designated Director of the study. Each Military Department and DLA is requested to nominate one individual to represent its Department in the study effort. Nominations should be furnished to this office within the next 20 days.

cc:
Dir., DCAA

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

15 October 1982

MEMORANDUM FOR MS. HUGHES

SUBJECT: SAF/FM Request for DCAA Survey of Compensation Rates

Reference is made to DCAA's attached format designed for the collection of data in response to SAF/FM's memorandum of 24 Aug 1982, Subject: Survey of Compensation Rates.

The DCAA format deals only with "Increases", and does not address "Compensation Rates" per se. I called that to the attention of your assistant, Colonel Goven, and he suggested that I discuss it with the DCAA action officer, Mr. Wayne Berry. Colonel Goven also said he did not receive a copy of DCAA's proposed letter of transmittal.

I telephoned Mr. Berry and he told me that:

1. This is a preliminary step and the results will be used as a basis for finalizing the overall plan for the compensation rate survey.

2. The format had already been distributed to DCAA's field offices on 12 October.

3. He would, as I requested, send me a copy of the transmittal letter that explains the compensation rate survey and the format to the DCAA field offices.

Request that you arrange a further meeting with the DCAA representatives as soon as practicable so as to keep the compensation review effort moving forward.

Colin D. Parfitt

Attachment

COLIN D. PARFITT
Assistant for Financial Systems

Copy to:
Mr. Fitzgerald
Col Goven
Mr. Wayne Berry
Mr. Ririe
(w/o attachment)

#6

Overview of Total Compensation
(COLA, GWI, Merit and Fringe)
Study Within Aerospace Industry

1. AF Concerns

a. Recent study indicates aerospace compensation (salary, wage, fringe benefits) rates significantly higher than BLS average manufacturing rates.

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Ford Aerospace and Conn (Newport Beach, CA)

G/D (Ft. Worth, San Diego and Pomona)

G/E (Evendale, Philadelphia (Space Systems Division Plus Re-Entry System)
West Lynn

GMC Delco Electronics Suboffice, Goleta, CA

Grumman (Bethpage, NY)

Honeywell (Minneapolis)

Hercules (Magna, UT)

Hughes (ElSegundo (Res), Tucson (Res), plus Helicopter, Culver City)

Garrett (Phoenix) (Los Angeles)

Lockheed (Georgia), (LMSC), (California, Burbank) (Palmdale)

Northrop (Hawthorne, CA plus Electromechanical, Anaheim, CA)

McDonnell Douglas (St. Louis), (Long Beach), (Huntington Beach)

Martin Marietta (Denver, Orlando and Baltimore)

Raytheon (Missile Systems, Bedford, MA)

Rockwell (International (LA)), Columbus (International Suboffice)
(Downey, CA), (Anaheim, CA)

Sperry Univac (Suboffice St. Paul) (Sperry, Great Neck, NY)

Thiokol (Suboffice Brighan City, UT)

TI (Richardson, TX)

Textron (Res. Bell Helicopter, Ft. Worth) (Bell Aerospace Textron, Buffalo, NY)

TRW (Redondo Beach)

UTC - (P&W West Palm and East Hartford), Sikorsky, Hamilton Standard and Chemical System Division

Vought (LTV) Dallas

Westinghouse (Baltimore)

CONTRACTOR NAME__________________________
LOCATION__________________________

	PERCENTAGE INCREASE															
	1978				1979				1980				1981			
	COLA	GWI	Merit	Total	COLA	GWI	Merit	Total	COLA	GWI	Merit	Total	COLA	GWI	Merit	Total
1. Engineering:																
a. Design Engineer																
Hourly	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
Salaried	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
% category is of direct labor $**				___				___				___				___
b. Research Engineer																
Hourly	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
Salaried	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
% category is of direct labor $**				___				___				___				___
c. Production Engineer																
Hourly	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
Salaried	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
% category is of direct labor $**				___				___				___				___
d. Other(______________)																
Hourly	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
Salaried	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
% category is of direct labor $**				___				___				___				___
e. Total Engineer																
Hourly	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
Salaried	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
% total category is of direct labor $**				___				___				___				___

**the percentage is of total direct labor dollars

Enclosure 1
Page 1 of 4

	PERCENTAGE INCREASE															
	1978				1979				1980				1981			
	COLA	GWI	Merit	Total	COLA	GWI	Merit	Total	COLA	GWI	Merit	Total	COLA	GWI	Merit	Total
2. Production/Manufacturing:																
a. Production/Manufacturing																
Hourly	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
Salaried	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
% category is of direct labor $**				___				___				___				___
b. Q.A./Test																
Hourly	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
Salaried	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
% category is of direct labor $**				___				___				___				___
c. Tooling																
Hourly	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
Salaried	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
% category is of direct labor $**				___				___				___				___
d. Assembly																
Hourly	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
Salaried	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
% category is of direct labor $**				___				___				___				___
e. Other																
Hourly	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
Salaried	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
% category is of direct labor $**				___				___				___				___
3. Other*________________																
Hourly	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
Salaried	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___	___
% category is of direct labor $**				___				___				___				___

*cannot be identified with Engineering or Manufacturing. Identify the category.

	1978	1979	1980	1981
4. Total Company Increase (includes COLA, GWI, Merit and any other)	___%	___%	___%	___%
5. Total Company Composite direct labor rate - (end of year)	$___	$___	$___	$___
6. Fringe benefits (leave, employee insurance plans, pensions, unemployment taxes, FICA, bonuses, stock options, profit sharing and thrift savings plans.)				
RATE (as a % of total labor $)	___%	___%	___%	___%
COSTS (from readily identifiable accounts)	$___	$___	$___	$___
7. Direct labor dollars	$___	$___	$___	$___
Indirect labor dollars	$___	$___	$___	$___
Headcount company-wide (end of year)	___	___	___	___
8. What percent of total headcount is union.				
Direct	___	___	___	___
Indirect	___	___	___	___

9. What is the Standard Industrial Classification (SIC) Code for the contractor? ______________________________

10. What is the contractor's mix of business? (Show for most recent year.)

YEAR 19____

SALES/COSTS	($000)
DoD:	
COST TYPE	
FIXED PRICE	
TOTAL DoD	$______
OTHER GOV'T	
COMMERCIAL	______
TOTAL	$______

LIST OF CONTRACTORS FOR AEROSPACE SURVEY

–	ATL	BOS	CHI	L.A.	PHILA	S.F
Resident Office - Honeywell, Inc., Minneapolis, MN						X
Hercules Inc. Suboffice, Magna, UT						X
Salt Lake Branch Office, Salt Lake City, UT						
Resident Office - Hughes/El Segundo, L.A., CA				X		
Resident Office - Hughes Aircraft Co., Tuscon, AZ						X
Hughes Helicopters, Inc. - Suboffice, Culver City, CA				X		
L. A. Branch Office						
Garrett Turbine Engine Co. Suboffice, Phoenix, AZ						X
Phoenix Branch Office, Phoenix, AZ						
Airesearch Manufacturing Co. Suboffice, Torrence, CA				X		
Inglewood Branch Office						
Resident Office - Lockheed - Georgia, Marietta, GA	X					
Resident Office - Lockheed Missile-Space Co., Sunnyvale, CA						X
Resident Office - Lockheed California Co., Burbank, CA				X		
and Palmdale, CA location				X		
Resident Office - Northrop Corp. - Hawthorne, CA				X		
Northrop Electro-Mechnical Suboffice - Anaheim, CA				X		
San Gabriel Valley Branch Office						
Resident Office - McDonnell Douglas Aircraft Co., St Louis			X			
Resident Office - McDonnell Douglas, Huntington Beach, CA				X		

Enclosure 2
Page 1 of 4

	ATL	BOS	CHI	L.A.	PHILA	S.F.
McDonnell Douglas Suboffice, Long Beach, CA Resident Office - Huntington Beach, CA				X		
Resident Office - Martin Marietta Denver Aero - Denver, CO						X
Resident Office - Martin Marietta Aero, Orlando, FL	X					
Martin Marietta Corp Suboffice - Baltimore, MD Baltimore Branch Office					X	
Resident Office - Raytheon Missile Systems, Bedford, MA		X				
Resident Office - Rockwell International, L.A., CA				X		
Resident Office - Rockwell Anaheim, Anaheim, CA				X		
Resident Office - Rockwell Downey, CA				X		
Resident Office, Aerojet General Corp., Sacramento, CA						X
Aerojet Electro Sys. Co. Suboffice, Azusa, CA Pasadena Branch Office				X		
Resident Office - AVCO Corp. - Lycoming Div., Stratford, CT		X				
Resident Office - Boeing Co. - Seattle, Seattle, WA						X
Boeing - Wichita Wichita Branch Office, KS						X
Boeing-Vertol Co. Suboffice, Philadelphia, PA Valley Forge Branch Office					X	

	ATL	BOS	CHI	L.A.	PHILA	S.F.
Resident Office - Fairchild Republic Div. Farmingdale, NY		X				
Fairchild Industries Inc. Suboffice, Germantown, MD					X	
Resident Office - Ford Aerospace & Comm., Newport Beach, CA				X		
Resident Office - General Dynamics-Ft. Worth, TX	X					
Resident Office - General Dynamics-San Diego, CA				X		
Resident Office - General Dynamics-Pomona, CA				X		
Resident Office - GE - Evendale, Cincinnati			X			
Resident Office - GE - Lynn, MA		X				
GE Space Systems Division & Re-entry System Div Valley Forge Brancn Office					X	
GMC Delco Electronics Suboffice, Goleta, CA Santa Barbara Branch Office						X
Resident Office - Grumman Aerospace Corp., Bethpage, NY		X				
Rockwell International Suboffice, Columbus, OH Columbus Branch Office			X			
Resident Office - Sperry Rand - Sperry Div., Great Neck, NY		X				
Sperry Univac Suboffice, St. Paul, MN St Paul Branch Office, Bloomington, MN						X

Enclosure 2
Page 3 of 4

	ATL	BOS	CHI	L.A.	PHILA	S.F.
Thiokol Suboffice, Brigham City, UT Salt Lake Branch Office						X
Resident Office - Bell Helicopter Textron Ft. Worth, TX	X					
Bell Aerospace Textron Suboffice, Buffalo, NY Buffalo Branch			X			
Resident Office - TRW, Redondo Beach, CA				X		
Resident Office - Pratt & Whitney, West Palm Beach, FL	X					
Resident Office - UTC Pratt & Whitney, East Hartford, CT		X				
Resident Office - UTC Sikorsky, Stratford, CT		X				
Resident Office - Hamilton Standard, Windsor Locks, CT		X				
UTC Chemical Systems Div. Suboffice, Sunnyvale, CA Sunnyvale Branch Office						X
Resident Office - LTV Corp., Dallas, TX	X					
Resident Office - Westinghouse, Baltimore, MD					X	

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

24 September 1982

MEMORANDUM FOR THE RECORD

SUBJECT: DCAA Aerospace Compensation Meeting - 21 Sept 82

Meeting was held to review/discuss DCAA plan for surveying defense industry labor and fringe rates to include trends during the past several years (see attached plan).

The meeting was held at HQ DCAA and the following personnel attended:

Marv Mercer	SAF/ALP
Dick Goven	SAF/FME
Wayne Berry	DCAA/O
Ray Logsdon	DCAA/O
Bob Ships	AF/RDC
Colin Parfitt	SAF/FM
Don Abby	AFSC/PMM

The plan was approved with the following annotations/comments

-- The study is not to be restricted to just direct labor rates--but must cover overall compensation; (salaries, wages, fringe benefits, bonuses and other remuneration).

-- As annotated in Attachment 1, recommended changes to milestones were made and additional contractors were added to the survey list.

The proposed survey form will be provided for our review.

RICHARD C. GOVEN, COL, USAF
SPECIAL ASSISTANT FOR COST
EVALUATION AND ANALYSIS

Overview of COLA ~~and GWI~~
Study Within Aerospace

Salary and wage and FRINGE benefit
compensation

1. AF Concerns

   a. Recent study indicates aerospace ~~labor~~ rates significantly higher than BLS average manufacturing rates.

   b. Projections of inflation are based on past history of high inflation rather than the current projected lower trend.

   c. Labor rate increases are based on nationwide rates rather than area wages.

2. DCAA Objective

To determine the actual Cost of Living Allowance (COLA) and General Wage Increase (GWI) of DoD contractors in the aerospace industry for the last four years.

3. Approach to Accomplish Objective

A survey form will be issued for completion by the DCAA offices cognizant of the contractors listed on Attachment 1.

The survey form will request the actual COLA and GWI for the last four years categorized by the contractor's major aerospace product line (airframe, missile and space, aircraft engines and parts, other). Where the increase cannot be separated between COLA, GWI and merit, the audit office will provide the combined totals. Upon receipt of the completed survey forms, we will analyze the data and prepare a summary. After completion of this first step, we will prepare an outline to discuss proposed approaches for further analysis of labor rate increases.

4. Potential Areas for Further Analysis

a. Whether the mix of business (Government/commercial) impacts the wage increases given? Whether the union agreements are negotiated top-down or by locality and if this could impact the agreements?

b. Whether the labor rates exceed the average geographic wage rates? If so, is there a reason for this, such as the job speciality/expertise/location?

* FRINGE Benefits
A Comparable Bench Mark

c. Whether our audit evaluation techniques are properly analyzing wage escalation and recommending current trends and not historic trends?

d. Whether the indices being utilized contain comparable data or whether nonrelated data is also included? Is there a better index?

e. Whether compensation system reviews are being performed or requested?

f. Whether the DAR cost principle 15-205.6 is too broad and needs more stringent language?

5. Milestones

a. Discuss the overview with AF	9/21/82	
b. Make any adjustments necessary	9/24/82	
c. Prepare and issue FAO survey questionnaire on COLA and GWI	10/1/82	
d. Receipt of questionnaire responses	~~10/2[illegible]/82~~	11/5
e. Complete analysis of responses	~~10/29/82~~	
f. Prepare an outline delineating future steps/analysis (Dates to be established after preliminary survey)	11/19	

List of Contractors for Survey

Aerojet (Sacramento and LA)

Avco Lycoming

Boeing (Seattle, Wichita and Philadelphia)

Fairchild Republic (Farmingdale and Germantown)

Ford Aerospace and Conn (Newport Beach, CA

G/D (Ft. Worth, San Diego and Pomona)

G/E (Evendale, Philadelphia (Space Systems Division Plus Re-Entry System)

West Lynn

GMC Delco Electronics Suboffice, Goleta, CA

Grumman (Bethpage, NY)

Honeywell (Minneapolis)

Hercules (Magna, UT)

Hughes (ElSegundo (Res), Tucson (Res), plus Helicopter, Culver City)

Garrett (Phoenix), LA

Lockheed (Georgia), (LMSC), (California, Burbank)
Lockheed Propulsion

Northrop (Hawthorne, CA plus Electromechanical, Anaheim, CA)

McDonnell Douglas (St. Louis and Long Beach)

Martin Marietta (Denver, Orlando and Baltimore)

Raytheon (Missile Systems, Bedford, MA)

Rockwell (International (LA)), Columbus (International Suboffice)

Attachment 1

Sperry Univac (Suboffice St. Paul)

Thiokol (Suboffice Brighan City, UT

TI (Richardson, TX)

Textron (Res. Bell Helicopter, Ft. Worth (Bell Aerospace Textron, Buffalo, NY)

TRW (Redondo Beach)

UTC - (P&W West Palm and East Hartford), Sikorsky, Hamilton Standard and Chemical System Division

Vought (LTV) Dallas

Westinghouse (Baltimore)

Attachment 1

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

9 September 1982

MEMORANDUM FOR THE RECORD

SUBJECT: DCAA Aerospace Compensation Study Meeting - 8 Sep 82

BACKGROUND

-- Meeting held to scope, set objectives, and define parameters for DCAA Study to be conducted in response to Secretary Hale's request of 24 August 82.

-- The following personnel attended:

Edward J. Trusela	SAF/ALP	56351
Dick Goven	SAF/FME	73909
Wayne Berry	DCAA/O	27-47344
Ray Logsdon	DCAA/O	27-47105
Robert A. Sands	AF/RDC	59043
Colin D. Parfitt	SAF/FMM	73617
Donn V. Abby	AFSC/PMM	98-15770

DISCUSSIONS

-- DCAA will prepare study plan and submit it to the group for review during the week of 20 Sep 82.

-- Preliminary plans are for DCAA to survey industry labor and fringe rates to include trends during the past several years. The exact scope, parameters, and time frame of the study will be finalized during the week of 20 Sep 82.

COMMENTS

-- The requested survey is underway and should provide a firm basis defense industry and federal government compensation comparisons. General consensus of the group was that the survey was needed and the planned scope and parameters were satisfactory.

RICHARD C. GOVEN

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

24 August 1982

MEMORANDUM FOR MR. STARRETT, DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Survey of Compensation Rates

Secretary Orr's attached memorandum to me expresses his concern regarding increases in defense industry compensation rates relative to compensation increases for Federal Government employees and retirees. We wish to more precisely determine the extent and magnitude of disparities in compensation benefit increases in conjunction with development of courses of action to control the costs of our weapon systems and would like to solicit your assistance in this effort.

I would appreciate it if your Agency would perform a survey to compare the rate of defense industry compensation increases with (1) the rate of increases in comparable industries and professions, and (2) the rate of increases in the Federal Government. I suggest your staff meet with representatives of Air Force Acquisition and Financial Management to definitize the scope, objectives and parameters of the survey. You may contact Ms. Hughes (697-3909) of my staff to arrange the meeting.

Russell D. Hale

RUSSELL D. HALE
Assistant Secretary of the Air Force
(Financial Management)

Attachment

SAF/LLL/Lt Col Puett/75322/15Sep82/bjr

→ Mrs. Hughes

H7130R

16 SEP 1982

Honorable Orrin G. Hatch
Chairman, Committee on Labor
and Human Resources
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

This is in response to your letter of September 7, 1982, to the Secretary of the Air Force regarding Air Force audits of labor rate increases in the defense industry.

The Air Force Audit Agency does not have responsibility for auditing records maintained by commercial enterprises contracting with the United States Air Force. These audits are conducted by the Defense Contract Audit Agency. We understand your staff has been in contact with the Department of Defense concerning these audit reports.

If we may be of further assistance, please do not hesitate to call upon us.

Sincerely,

CLIFFORD H. REES, JR.
Brigadier General, USAF
Deputy Director
Legislative Liaison

CC: SAF/OS
SAF/FMR

6

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON, D.C.

28 SEP 1982

REPLY TO ATTN OF: AFAA/AI

SUBJECT: GAO Review of the Impacts of Foreign Source Dependency on Industrial Base Responsiveness (Code #947483)

TO:

X SAF/AL
SAF/FM
X ~~SAF/FMB~~
SAF/GC
X SAF/LLW
SAF/MI
SAF/OS
X SAF/PAM
SAF/SS
SAF/
SAF/

X AF/AC
AF/ACBMD
AF/ACD
AF/ACFS
AF/ACMMR
AF/CVA
X AF/IGI
AF/JACM
AF/INYR
X AF/LEA
AF/MPXJ

AF/PR
AF/RECA
X AF/RDXM
AF/SGHC
AF/XOOIJ
NGB/AC
AF/
AF/
X AFAA/XPP
X AFISC/DAP
AFTEC/AC

ADC/ACM
AFCC/AC
X AFLC/IGQ
X AFSC/PMXG
ATC/ACMX
MAC/XPSA
PACAF/ACFA
SAC/ACX
TAC/ACFQ
USAFE/ACMI
AFAFC/AJQ

Attached copy of GAO letter of 15 September 1982, which advises of the termination of subject review, is forwarded for your information. No report will be issued at this time.

→ Mrs. Hughes
Kim - You may be interested in the GAO effort discussed in the last para of the attached letter.
John

Basil H Pflumm
BASIL H. PFLUMM, Colonel, USAF
Assistant Auditor General

1 Atch
GAO Ltr, 15 Sep 82

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

PROCUREMENT, LOGISTICS, AND READINESS DIVISION

LABOR

SEP 15 1982

The Honorable Caspar W. Weinberger
The Secretary of Defense

Attention: Assistant for Audit Reports

Dear Mr. Secretary:

In March 1982 we began a review to assess the impacts of foreign source dependency on industrial base responsiveness (code 947483). Our principal objectives were to determine:

--how the procurement of industrial machinery, weapon system components and other material from foreign sources impacts the capability of the U.S. industrial base to meet surge and mobilization requirements,

--the steps taken by DOD to assure that adequate domestic capability exists in these areas for potential surge and mobilization situations, and

--additional actions available to eliminate or minimize impacts from foreign source dependency in these areas.

We have done some work on this subject at the Office of the Undersecretary of Defense for Research and Engineering and the San Antonio Air Logistics Center, Kelly Air Force Base, San Antonio, Texas. We also contacted Department of Commerce officials and visited one major aerospace contractor.

Our work disclosed that although problems ensuing from foreign source dependency had been identified for some items, the full extent of foreign source dependency for components and parts is not known. Also, there is currently no data base available which would provide such information for our analysis.

* GAO's Institute for Program Evaluation (IPE) has recently undertaken an assignment entitled "Shortages in Critical Components, Labor Skills, and Commodities: An Evaluation of Their Impact on Defense and Non-Defense Production Needs." As part of this assignment IPE plans to develop a new methodology with which to identify critical components and commodities, areas of foreign dependency, and the reasons why certain components are manufactured abroad. Since IPE's methodological work will address the foreign source dependency area, we have decided to terminate our work under code 947483.

Sincerely yours,

John Landicho
Senior Associate Director

cc: Auditor General (DAIG-AI)
Comptroller of the Navy (NCB-53)
Assistant Auditor General (AF-ACUG)
Directors, PLRD and IPE
Regional Manager, Dallas

6

STEEL: Industry Crisis Intensifies

- Three major dilemmas of the domestic steel industry have developed to critical proportions in the summer of 1982. The industry's future competitive health and, ultimately, its structure and size may depend on their favorable resolution.

  (1) Three consecutive years of below-normal markets have brought industry shipments to a first-half 1982 level lower than for any similar period in the past 21 years, and industry employment to the lowest point since the 1930's; over 100,000 workers are laid off. Industry shipments for 1982 may total no more than 70 million tons; for the decade of the 1970's, shipments averaged 95 million tons annually.

  (2) Imports of steel mill products -- after accounting for a record 19.1 percent of the 1981 domestic market -- have continued to increase in the first half of 1982, reaching 22.6 percent. U.S. producers have filed numerous complaints under the Trade Act, charging subsidy and dumping of imports, mainly from the European Community (EC); the Commerce Department has compiled substantiating evidence in many of these cases. In the meantime, a negotiated commitment by the EC to apply quotas on their steel exports to the United States has been rejected by U.S. steel producers as inadequate restraint on imports.

  (3) Hourly labor costs in the steel industry -- negotiated by the United Steelmakers of America (USW) under a no strike agreement -- have risen an average of 12 percent per year over the past 10 years. They have progressively outpaced manufacturing wages; the average steelworker receives $13.77 per hour, 63 percent above the manufacturing sector average (on the basis of compensation including fringe benefits, the discrepancy is apparently even greater), and substantially above that received by EC and Japanese steel workers. In a bid to make their costs more competitive, the industry proposed scaling down benefit increases projected in the current USW contract; this proposal was unanimously rejected by presidents of the 400 USW locals.

ENCLOSURE 7

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

25 MAY 1983

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)

SUBJECT: Request for Audit Reports - ACTION MEMORANDUM

I know you are concerned, as are we, over the recent settlement agreement between the Justice Department and Rockwell in the matter of deliberate mischarging of direct labor hours to government contracts. Similar cases are now underway at other contractors. I believe this is just another indication that "all is not well" with regard to the labor component in our defense work.

In an effort to gain more insight into the extent of the specific problem of labor mischarging in the Air Force, we asked DCAA to cooperate with us and provide copies of any reports they had that would allow us to attack the problem and focus top-level attention on the appropriate issues (Atch 1). Our request was intentionally left very broad so that DCAA would not feel constrained in applying their experience/expertise to answering our query. Moreover, to clarify our concerns, we followed up our request with informal dialogue with top officials at the agency so that they would (1) clearly understand what our problem was, (2) why we were interested in it, and (3) feel free to offer a better solution.

DCAA's response (Atch 2) to our request for assistance leads me to question whether or not we are "playing on the same team." We understand DCAA has recently completed audits in the specific functional area we are interested in, and that over 100 such audits are now underway at various locations. Further, at one regional DCAA office we know of, an automated cataloguing exists (by labor functional area) of audit efforts currently underway in that region. Based upon these existing reports, it seems to me the Agency could be considerably more helpful than their letter suggests.

Vince, as you know, DCAA is a very important part of our contract administration team. In the past, DCAA auditors have been extremely helpful; however, I believe they could be even more aggressive in helping us to improve the way we are doing business. In this regard, I am soliciting your assistance in getting the Agency to be more helpful and imaginative in working with us, and furnish as soon as possible the specific reports we need to get into the labor distribution/mischarging problem.

Russell D. Hale

RUSSELL D. HALE
Assistant Secretary of the Air Force
(Financial Management)

2 Atchs

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

28 APR 1983

MEMORANDUM FOR THE DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Request for Audit Reports

As you know, we have been working for sometime to increase cost consciousness in the administration of Air Force contracts. We began our efforts over a year ago with an in-depth look at labor rates and labor content as a major element of total unit costs. I believe significant progress has been made; however, it is fairly evident we need to continue to direct high-level attention to these areas. Specifically, I am concerned over the recent settlement agreement between the Justice Department and Rockwell in the matter of deliberate mischarging of direct labor hours to government contracts. The mischarges in that case amounted to millions of dollars over a long period of time. We understand a similar case is now under review at Litton Industries. Further, during a visit last year to a contractor's plant, we observed the arbitrary distribution of "actual" hours to jobs (contracts) in one cost center.

The implementation in Air Force contracts of MIL-STD 1567, Work Measurement, should improve our cost control capabilities and provide the basis for an auditable, built-in check to discourage or preclude arbitrary charging of "actual" hours to jobs or contracts by workers, supervisors or management. Moreover, changes in the general trends of observable variances between direct labor standard hours and the elapsed hours actually attributed to jobs/contracts should provide early warning regarding possible inconsistencies.

To assist us in gaining an overview of the current status of accounting for direct labor by Air Force contractors, I am requesting that you provide us with copies of all DCAA audit reports completed during the past two years that deal directly or indirectly with defense contractor direct labor hours/costs distribution to Air Force contracts. Further, we would appreciate receiving from you a list of DCAA audits of direct labor distributions currently in process or planned to be undertaken during the remainder of the calendar year. We would like to receive requested documents by 20 May 1983.

Russell D. Hale

RUSSELL D. HALE
Assistant Secretary of the Air Force
(Financial Management)

DIST: SAFFM SAFFMA SAFFMM AFCVAE
SAFFMB

DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VIRGINIA 22314

IN REPLY REFER TO

Copy to SAF/FM
SAF/FMA
SAF/FMP
SAF/FMC

13 MAY 1983

OTD
703.4.82

MEMORANDUM FOR ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT)

SUBJECT: Request for Audit Reports

I want to assure you that we in the Defense Contract Audit Agency (DCAA) are as concerned as you are about the recent settlement agreement between the Justice Department and Rockwell International. Particularly since we were so intimately involved in that case for the past 3 years.

Your 28 April 1983 letter, stated that implementation of MIL-STD 1567, Work Measurement, should improve cost control capabilities and provide the basis for an auditable, built-in check to discourage or preclude arbitrary charging of labor hours to jobs or contracts by workers, supervisors, or managers. I agree that implementation of MIL-STD 1567 would improve a contractor's cost control capabilities. However, it is the contractor's system of existing internal controls that assures the reliability and integrity of labor charges to a contract and therefore are more important in guarding against labor mischarging.

The labor accounting and management systems at major defense contractor locations are under continuous review by DCAA through performance of a number of audits made on a functional basis. These labor functional areas include (i) review of internal controls, (ii) review of personnel policies and procedures, (iii) review of recruiting costs and practices, (iv) evaluation of quantitative and qualitative utilization of labor, (v) review of timekeeping procedures and observations of work areas (floor checks), (vi) review of payroll preparation and payment, (vii) review of overtime, extra pay shifts, and multishift work policies and costing, and (viii) verification of labor costs.

During the period 1 October 1978 to 31 March 1983, DCAA has referred for investigation 59 instances of labor mischarging involving over $20 million. Requests for information regarding contractors under the cognizance of Air Force Administrative Contracting Officers (ACO) would have to be addressed to the Office of Special Investigations.

DCAA has been involved both directly and indirectly with problems associated with contractors' labor standard/work measurement systems. Lack of an adequate labor standard/work measurement system has been a common operations audit finding reported in major audit areas such as direct production labor and related supervision, facilities management, maintenance and calibration of test equipment, production scheduling and control, and quality assurance. Several of our operations audit

13 MAY 1983

SUBJECT: Request for Audit Reports

pamphlets contain audit guidelines to determine if the contractor's operations have these minimum requirements (which are characteristics of a good work measurement system).

DCAA's operations audits have made effective use of MIL-STD 1567 and have resulted in significant cost savings and/or avoidances to the Government through improved economy and efficiency of contractor day-to-day operations.

You requested that DCAA provide your office with copies of all DCAA audit reports issued in the last 2 years that deal directly or indirectly with defense contractors' charging of direct labor hours/dollars to Air Force contracts. During the past 2 years I would estimate that DCAA has issued about 10,000 audit reports that are related to various aspects of thousands of defense contractors' labor accounting and management functions. We have no readily available means of identifying these reports. However, we are confident that our auditors are continually providing assistance to adminstrative contracting officers who are charged with the responsibility for obtaining appropriate corrective actions from DoD contractors. Under the circumstance we do not believe that you would obtain an overview of the current status of accounting for direct labor costs from the audit reports. This information should be obtained from the cognizant administrative contracting officers. They could also, provide you with the current status of any decisions and/or corrective actions taken relative to the deficiencies reported in our audit reports.

You also requested that we furnish you a list of DCAA audits of direct labor distributions currently in process or planned to be undertaken during the remaining calendar year. As I mentioned above, the labor accounting and management systems at major defense contractor locations are under continuous review by performing a number of audits in various labor functional areas. The data you requested would be voluminous and subject to continual updating. The annual audit program plans are coordinated with the cognizant ACO at each major defense contractor location.

If you need to discuss this matter further you may contact Mr. Phillip E. Rogers, Program Manager, Technical Programs Division, at 274-7344.

C. O. STARRETT, Jr.
Director

Statement
of
Mr. John Q. Thompson, CPA
P.O. Box 3251
Huntsville, Alabama 35810

Former employee of DCAA
Dallas, Texas

For the Senate Committee on Governmental Affairs
Hearing on DCAA Management and Operations
March 1, 1984

Mr. Chairman and Members of the Committee:

It is with pleasure that I submit to you this statement of my observations as a former goverment contract auditor with ten years of experience, including seven with the Defense Contract Audit Agency (DCAA).

I am a graduate of the University of Arkansas and have been a licensed Certified Public Accountant in Texas since 1959. I worked for the DCAA as a supervisory auditor from 1965 until I was forced out in 1972. I am now employed in private industry.

I began my career as a government auditor with the Navy in 1963, prior to the establishment of the DCAA. My first audit assignment in the Navy was at the LTV plant in Grand Prairie, Texas where on my very first audit I questioned $700,000 in costs which LTV incorrectly claimed it had incurred on a current contract. The Navy rewarded me for my enthusiasm and resourcefulness on this audit by transferring me to its audit staff at Texas Instruments (TI). Because of well-known audit "access to records problems" there in 1963, Texas Instruments was considered the "Siberia" of audit assignments by Navy auditors.

Before beginning my job at TI, I had a chat with a government auditor who is now generally recognized as the "patriarch" of government auditors in the Dallas/Fort Worth area, having over 25 years contract audit experience when he retired a few years ago. At the time I transferred to the audit staff at TI he predicted that the first time I attempted to audit the company, I would have to make an appointment in advance to talk to someone in the accounting department. He ended the conversation by saying that he would retire rather than accept an assignment to the government audit staff at Texas Instruments. Based on his comments, I began my new TI assignment with a sinking feeling, but I was determined to do the best job possible.

Unfortunately, the picture the audit patriarch painted was a fair representation of the situation I encountered at TI. Every stumbling block possible was thrown in the way of my audit efforts. For example, when I finally did get in to see the TI accountant and asked for accounting support for a cost presentation, he asked me why I needed the documents. After I finally convinced him of my need for the requested documents, he told me it would take another week to clear their release through proper channels.

Even after DCAA took over all DoD contract audit responsisbilities in 1965, I had to fight for the right to enter every single manufacturing area and to gain access to cost accounting records at TI. I found myself involved in a constant 'chess match' with TI officials. My problems were compounded by the fact that I received no help from the government Administrative Contracting Officer at the plant or from the DCAA Regional Office in Atlanta. To put it bluntly, I was on my own. TI wouldn't even let their employees talk to me.

One day, after I spent two hours pleading with the General Manager for permission to enter the manufacturing area, he told me the only freedom I had at TI was to travel the route from my office to my car in the parking lot. On another occasion when I tried to arrange to observe employee clocking-in procedures in the manufacturing area I was told the manufacturing area was off limits to auditors. Liberally spicing his reply with expletives, the General Manager informed me that he did not want me to talk to his employees, and he refused to give me permission to enter the plant. I thought perhaps that cooler heads had finally prevailed when the Plant Manager interceded by saying that he had no objection to our observing employee clocking in procedures.

Unfortunately, the Plant Manager's statement indicating we would have audit access did not represent company policy. On Monday morning at 6:00 a.m., accompanied by my two assistants, I entered the manufacturing area. It was my plan to stand at the employee time clock nearest the entrance and have my assistants observe clocking-in procedures at another clock farther inside the plant. I was shocked and surprised when the General Manager greeted me at the door and then warned every employee that entered that I was a government auditor and not to talk to me. Because of the General Manager's orders to his employees, my audit work at the clock nearest the entrance was of little value. My assistants, however, obtained more meaningful audit results at the other clock because the General Manager's attention was directed exclusively to me and to the TI employees clocking in near me.

Once again, these kinds of enthusiastic audit efforts earned me a transfer, this time in DCAA, and this time to E-Systems in Garland, Texas.

Shortly after my transfer to the E-Systems audit staff, I had an interesting conversation with a company employee whom I met near my home. He did not know that I was a DCAA auditor, and complained to me that E-Systems was losing many commercial jobs apparently because the company's general and administrative (G&A) expense rates were so high that the company couldn't compete with other suppliers. I told him that the best way (and to me the only way) to remedy the situation was to reduce G&A expenses. I was well aware that the G&A rate was high.

A few days later E-Systems developed and proposed a new G&A rate to the government, but with an unusual twist. No attempt was made to reduce G&A expenses. Instead, the contractor eliminated material costs from the base for computing the G&A

rate. This arbitrary action would obviously reduce the G&A rate and improve E-Systems' business. What the contractor failed to mention was that elimination of these material costs from the base would also result in the allocation of 6 percent more G&A expenses on government contracts.

Needless to say, in the audit report I issued, I questioned the use of this accounting maneuver. Several days later, however, DCAA Regional Manager Paul Evans came to Dallas and berated me for issuing the report. Subsequently, my report was withdrawn and a revised report was issued condoning the contractor's proposed method for determining the G&A expense rate. Unfortunately, the subsequent allocations of excessive G&A expenses to government contracts indicated that the taxpayer was a big loser too. As a result of issuing the audit report in which I took exception to the contractor's new way to allocate G&A expenses I was harassed for months and finally was forced out of the agency.

In closing, I wish to commend the Committee for initiating this oversight hearing on DCAA and Senator Sasser for introducing a bill to abolish DCAA. I would also like to add the following comments and suggestons:

1. DCAA should be transferred from the control of the Assistant Secretary of Defense (Comptroller) to the DoD Inspector General. DCAA is obviously not independent of the Defense Department's acquisition community and too many of its employees are too chummy with defense contractors. (I believe the DoD Inspector General is sufficiently independent of the DoD procurement establishment to improve the effectiveness of contract audit operations.)

2. In my judgement, contract auditors must have complete and prompt (within 24 hours in most cases) access to contractor records if they are expected to do a competent job (and the majority of DCAA auditors are technically competent).

3. I also suggest that action be taken to close the loophole which allows a prime contractor, after signing a certificate of current pricing, to re-enter negotiations with the supplier to further reduce the price a supplier has quoted him. Corrective action should require, at a minimum, that the negotiated prime contract price be reduced.

4. Action must be taken to provide some form of meaningful penalty to contractors who make a habit of denying DCAA auditors access to the accounting records. Such actions should include the debarment

or fining of recalcitrant contractors, or at least suspending further payments to them. Based on a conversation I recently had with a DCAA auditor currently at Texas Instruments who wished to remain anonymous, it appears the company's treatment of DCAA auditors has not changed in the ten years since I was assigned there. The transcript of the auditor's comments is attached to this statement.

I believe that at least $30 billion could be saved each year if DoD were to adopt more businesslike management and procurement procedures, including fully independent and effective contract audit support, to thus create the most competitive and cost-effective procurement environment possible.

Comments Re: Current Status of Access to Records Problems, by DCAA Auditor Currently Assigned to the Agency's Office at Texas Instruments in Dallas, Texas

One of the things that is required is that when you ask for a record pertaining to a pricing proposal, it usually would be given to you in the presence of two accounting people. Another thing, if you want to get some information backward or forward of the pricing period you might presently be looking at, you would have to make the request in writing, particularly if you want to evaluate forecasts or things like that based on data prior to the proposal period and following it. Requests for anything that would give you an indication of how the trend of the costs was going would have to be in writing, and usually it would take days or sometimes weeks before you would get a reply to those requests. Sometimes when you got it, you would only get one document summarizing the data you requested -- the whole file would be empty except for that one document -- no supporting data. You wouldn't get a complete file; you would just get that one particular piece of data by itself.

There are other things that they would do to frustrate your requests for certain other data. They would say, "this is not an accounting record," and then they would argue and fight with you, and say you weren't entitled to it because it wasn't an accounting record.

I recall one case where a request was made in writing for certain data , and it took six months of hard fighting to get it. (By the way, the data indicated that an item which costs TI only $200 was actually sold to the government for $800.) In this case, and in all of these cases, the auditor's fight for access to records had to be fought all alone, as a single auditor, because buyers in the resident DCASPRO (Defense Contract Administrative Services Plant Representative Office) gave no support. The DCASPRO never supported the auditor. In fact, they were like putty; they just wouldn't support any request for access to TI records. The DCAA auditor was usually on his own, which is the same way it was ten years ago. He fought the battle alone. He didn't get any support from the resident auditor, his regional supervisors or the DCASPRO commander.

Several years ago, DCASPRO personnel and DCAA auditors both used the same kind of TI badges for admission to the plant. Then, as a matter of harrassment, TI took the DCAA auditors' badges away from them, and gave them the kind of badges that outsiders, such as plumbers and other type of repairmen, were issued to more closely control their in-plant movements. If an auditor forgot to wear the badge, they would make him sit in the lobby for hours until they, very slowly could find somebody, like a contract administrator, to come and get him and escort him back to his desk in the area assigned to DCAA. In the meantime, the auditor might have lost two or three hours of working time. When the auditors asked why DCASPRO's badges weren't taken away and theirs were, the TI employees told them, "the DCASPRO people are our friends." This sounds familiar, doesn't it? It was only after a threat by one of the auditors to go to the U.S. Attorney's office for depriving him of his right to work that TI again issued the same badges that the DCASPRO personnel were wearing. It was just a form of harrassment. That was several years ago, mind you, seven or eight.

TI also uses another practice so many other contractors do. They'll convince the cotracting officers to negotiate a fixed price contract, and get a vendor quote of $100 for a gadget. Then, after you see that quote and the government signs a fixed price contract, they'll go out and renegotiate the vendor price for the gadget and wind up paying only $75 for it. They'll say the difference is that we went out and beat 'em down, but the point remains that the government doesn't get any benefit at all from the lower vendor price. I believe they deliberately get higher quotes, knowing that they will beat them down later. That's not an unusual practice by the way.

TI will still not let an auditor into the cost accounting department. The resident auditor is afraid of TI, and he was ten years ago too.

Source: Based on a recorded telephone conversation with a DCAA auditor currently assigned to the DCAA staff at Texas Instruments.

NOTES ON COMMITTEE INVESTIGATORS' REVIEW OF DCAA REPORT "MEMORANDUM AUDIT REPORT ON SPECIAL REVIEW OF TIMEKEEPING PRACTICES IN THE PROCESS SHOP AREAS, HUGHES AIRCRAFT COMPANY" TUCSON, ARIZONA, AUDIT REPORT NO. 7471-3A130104-001

DTD. June 30, 1983

The audit was requested by the ATSD(R&O) on 16 December, 1982; the DCAA report was dated 30 June, 1983. The ATSD(R&O) request for audit indicated a desire for prompt attention based on the serious situation reported by an Air Force official (Mr. Fitzgerald).

Field Audit Work:

- DCAA spent a total of 272 hours on the audit.
- All field audit work was done in January, 1983.

Scope of Work:

- By consultations with AFPRO people and perhaps Hughes people and preliminary access to Hughes data, the audit was concentrated on 82 hourly employees in 6 departments involving 'processing shops'.
- The DCAA auditor in charge (AIC) told the Senate investigator that all 6 of the departments audited had been moved to another building between the time of Mr. Fitzgerald's observations and the time DCAA conducted their audit.
- In response to a question by the Senate investigator, the AIC said that, although the ATSD(R&O) request for audit was phrased in general terms and did not clearly identify the specific departments involved, he did not contact the ATSD(R&O) or Mr. Fitzgerald for clarification or other information before commencing the audit or at any other time.
- The work was done by a DCAA auditor out of the agency's San Francisco office, not by an auditor on the Hughes-Tucson residency staff. (Impact would be on orientation and learning curve - i.e., getting up to speed on Hughes' labor accounting and timekeeping procedures).
- Although Hughes-Tucson employs several thousand people, the audit scope was limited to 6 departments with a total of 88 people, including only 82 hourly employees.
- In a sample of 13 of the 82 employees selected on a random basis, the auditors conducted interviews and determined the following findings:

  a. 5 of 13 did not have timecards current (38%).

  b. 3 of 13 had signed their timecards in advance (23%).

c. 10 of 13 were using improper correction procedures, and instead used white outs, erasures and other unauthorized means to adjust time charges (77%).

d. 2 of 13 stated that they performed work on jobs for which they did not have workorder numbers to charge (15%).

e. 9 of 13 said they estimated or allocated their labor charges to workorders rather than charge the actual time they worked on each job (69%).

f. 13 of 13 had timecards either in their possession or back at their work station. (100%) The auditors concluded that this situation apparently represented adequate internal controls or at least indicated that the employees, not their supervisor or foreman, had control over time charging. Actually there is still a distinct possibility that the supervisor or foreman could mark or alter employee time charges particularly on timecards kept back at the work stations.

Other Observations by the DCAA auditors

o The auditors found a situation similar to the condition observed by Mr. Fitzgerald in one of the 6 departments audited (a process shop with just 3 hourly employees). The auditors found that one employee kept the timecards for all three employees and recorded their times as well. The auditors concluded that this was okay...(and commented along those lines in the audit report).

Audit Workpapers

o W/P A - 2/29 refers to a prior audit report (7471-1A105103-001 dated 15 June, 1981) which states that there was excessive idleness of 14% at the Hughes Tucson plant. This 14% idleness is in addition to the 13% idleness identifiable to break periods, personal time, wash-up periods, work station clean-up and minor delays...a total idleness rate of 27% of all production labor.

o W/P A - 14/1-2 states that the AFPRO does not review the contractor's system with regards to labor costing.

o W/P A - 14/3 states the conclusion based in part on observation above (in W/P A - 14 1/2) that "...risk in this area (MRP & 1811 systems which generate production work orders and assign labor to contracts) is still high and should be reviewed.

- W/P I - 1/4 contains a computation of the possible impact of 2 of 13 people working on jobs for which they did not have workorders to charge. One of the 2 employees estimated this amounted to about four hours each week. The auditor's logic follows:
  - 2 of 13 = 15%
  - 88 employees in the 6 departments audited
  - 15% x 88 people = 13 people who might be working on jobs without workorders
  - 13 people x 4 hrs per week x 50 weeks = 2,600 hrs per year
  - Labor rate est. = $11.95 per hour
  - 2,600 hrs x $11.95 per hour = $31,070
  - Add burden @ 129.9% = $40,360
  - Total labor & burden = $71,430
  - Gov't participation = 45%
  - Total impact to Govt. = $32,144

Based on the above compution, the auditor concluded that the potential impact was insignificant, since the $32,144 represented only about 1.5% of the estimated annual pay, $2,187,328, of the 88 employees in these 6 departments. The auditor, however, did not include either general and administration costs or profit in the computation of potential impact and did not project the computation for the 6 departments to the entire hourly work force which numbers into the thousands of production workers.

What the DCAA Report Stated

- Paragraph 2a of the report concludes that:

  1. There was "...no evidence that supervisors were filling out timecards for employees."

  2. "Hughes-Tucson's timekeeping and labor recording practices in the areas selected for audit are adequate."

- In paragraph 2b, a conclusion that: "Perambulations and observations showed that employees generally have their timecards on their person or at their workstations, and were filling out their own timecards. Further, interviews of employees and supervisors did not disclose any indication of supervisory manipulation of labor charges at timecard level"

- In report paragraph 2c, a comment that the reported internal control weaknesses were not found ..."

Some Things Wrong With This Audit

1. Auditor didn't bother to contact either the ATSD(R&O) who requested the audit or Mr. Fitzgerald who observed the

deficiencies in controlling labor, even though the auditor said the request raised some questions regarding locations of departments and seriousness of deficiencies.

2. DCAA put only 272 hours on this audit even thought the following items indicated potentially serious labor charging problems at the Hughes-Tucson plant:

   (a) The Air Force found that actual labor charged to Maverick missile production was 17 times greater than the engineered standards for this work.

   (b) Mr. Fitzgerald had actually observed that supervisors in two departments controlled their employees timecards. (The auditors could have called Mr. Fitzgerald by telephone to identify the departments Mr. Fitzgerald visited and in which ones he observed the timekeeping deficiencies.

   (c) A Tucson newspaper reported that Hughes-Tucson employees were manufacturing HBO television receiver sets in the plant and selling them. (This situation, if true, would involve the unauthorized application of labor and material costs to Government contracts.

   (d) DCAA workpapers indicate that idle time at the Hughes-Tucson plant may amount to about 27% of the entire direct labor pool. (See reference to prior audit in comment on W/P A-2/29)

3. In spite of the sense of urgency stated in the ATSD(R&O) request for audit, the report wasn't issued until 5 months after the audit had been conducted. (And Mr. Fitzgerald still hadn't been informed of the audit results until the Committee investigator notified him of them on February 14, 1984).

4. No mention was made in the report that the departments included in the audit scope had been moved from building #801 to another building subsequent to the time Mr. Fitzgerald made his observations.

5. The audit findings in the workpapers do not support the conclusions stated in the audit report. In fact, the findings are in direct conflict with the conclusions.

EXCERPTS FROM JOINT DCAA/AFCMD REPORT ON REVIEW OF DIRECT PRODUCTION LABOR AND RELATED SUPERVISION AT HUGHES AIRCRAFT PLANT, TUCSON, ARIZONA

Report No. 7471-1A105103-001 dtd June 15, 1981

The review (conducted in February 1981) was performed to evaluate the (i) adequacy and effectiveness of policies, procedures, practices, and internal controls, (ii) effectiveness and efficiency of operations, and (iii) acceptability of methods of accounting for costs and compliance of such methods with Defense Acquisition Regulations and Cost Accounting Standards.

2. Scope of Review.

a. The review of financial, accounting, and related aspects was performed in accordance with generally accepted auditing standards and included such tests of accounting records and other auditing procedures we considered necessary in the circumstances.

b. DCAA and AFPRO personnel participated in the review, which included (i) evaluation of policies, procedures, practices, and controls, (ii) scheduled observations of randomly selected work stations, (iii) perambulations throughout the plant site, including hallways, vending areas, and break rooms, and (iv) interviews with selected supervisors and Government representatives.

3. Background Information. Our review involved three Tucson Manufacturing Division direct labor categories: Fabrication and Tooling, Assembly, and Inspection and Test. In January 1981, these categories included 841 employees, which represent 47 percent of the direct labor workforce. Effective management and supervision of direct labor is especially important because of its significance and because direct labor charges are used in making indirect cost allocations.

4. Summary Evaluation. Our joint review disclosed that direct labor productivity could be increased if HAC strengthened management controls. Using work sampling techniques we found that there is excessive idleness at the work station. In addition, we observed instances of significant nonproductivity away from the work station during nonbreak periods. We estimate that by strengthening supervisory controls

and more effectively using its work measurement system, HAC can avoid costs of about $5 million annually. HAC generally concurred in our observations and has taken actions and plans to take further actions to correct the problems noted. Detailed results of our review are presented in Appendix 1.

5. Concluding Remarks.

a. The assistance, cooperation, and interest of HAC personnel facilitated accomplishment of this review and demonstrated an earnest desire to improve operations. We provided a draft statement of condition and recommendations to HAC, and its reaction is included as Exhibit A.

b. We will provide any additional services which may be required in connection with the review and implementation of our recommendations. After an appropriate period of time, we intend to review HAC actions taken in response to the recommendations.

AIR FORCE CONTRACT MANAGEMENT DIVISION

JUD H. KLINGENSMITH, Colonel, USAF
Commander, Detachment 36

DEFENSE CONTRACT AUDIT AGENCY

for JEANNE G. DAVIS
Resident Auditor

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STATEMENT OF CONDITION AND RECOMMENDATIONS

1. Condition.

HAC management controls need strengthening to improve the productivity of direct production workers. Using work sampling techniques we found that, in addition to break, wash up and clean up periods, observed nonproductive time was 20 percent. For the production areas we observed, HAC allows a nonproductive time factor of 6 percent. As a result, there is excessive idleness of about 14 percent. By strengthening supervisory controls and more effectively using its work measurement system, HAC can reduce excessive idleness and avoid direct production labor and related supervision costs of about $5 million annually.

HAC's work measurement system provides for the following personal, fatigue and delay allowances for the production areas we observed:

	Minutes
Break Periods (2 @ 10 minutes each)	20
Personal	10
Wash Up Periods (2 @ 5 minutes each)	10
Work Station Cleanup	5
Minor Delays	18
Total	63

Using work sampling techniques and the criteria shown in Appendix 3, we made over 400 observations to measure direct production labor utilization during the week of 9 February 1981. Our possible observation times were limited to 445 minutes of the 480-minute workday. We made no observations during break (20 minutes), wash up (10 minutes), or work station cleanup (5 minutes) periods (480 - 35 = 445). Therefore, we consider observed idleness exceeding the allowances for personal and minor delays to be excessive. The computation of excessive idleness follows:

	Minutes	Percent
Observed idleness		20
Allowable idleness:		
Personal	10	
Minor delays	18	
Total allowances	28	
Allowable idleness factor (28 min. ÷ 445 min./workday)		6
Excessive idleness		14%

The computed amount of excessive idleness includes only the nonproductive activity observed at work stations. Although we did not determine the activity of workers absent from their work station at the time of observation, we noted that such absences were frequent. While employees may leave their work stations to perform productive activities, we noted numerous instances of nonproductive activity in hallways and break areas during nonbreak periods. For example, we observed prolonged loitering by individuals and groups for periods up to 25 minutes in vending machine areas. We also observed many long telephone conversations, some over 20 minutes, by production workers at pay telephones. While we did not include these observations in our calculations of excessive idleness and potential cost avoidance, we consider them to further support our conclusion that significant productivity improvements are possible. HAC can improve productivity by strengthening supervisory controls to assure employees are complying with company work rules regarding break times.

We also found that supervisors are frequently absent from work areas under their responsibility. In one instance, we found a supervisor who is responsible for two work areas in different buildings. During an interview, he stated that when he is in one area, he believes employee productivity in the other area suffers. Another supervisor's assigned employees are widely dispersed in several production areas. As a result employees are without supervision for a significant portion of the workday. Observed idleness for this department was above the average while idleness in other departments where supervisors spend more time at the work station was below the average.

Productivity can also be improved by more effective use of work measurement. Not all supervisors regularly review employee performance indexes or emphasize the importance of striving to achieve standard. Most HAC employees do not achieve standard--to do so on a sustained basis is unusual. We believe observed excessive idleness contributes to this condition; however, one department we reviewed did achieve standard during the week of our observations. The supervisor stated that of the several departments on the program, his employees continually perform the best and operate at standard. We also learned that his department has an unwritten policy granting two additional 10-minute breaks per day to those employees required to stand while working. Our observations disclosed a 20 percent idleness factor for this department. One department achieving standard despite informal breaks and 20 percent work station idleness, while other departments operate at much lower productivity levels, indicates that management and supervision are not using work measurement effectively. Standards should be achievable, but should not be set at a level that can be achieved even with excessive idleness.

In addition to generally limited use of performance reports, and standards set at improper levels, we also found that the reliability of the HAC work measurement system's output is questionable. The system's source of information is production and work order reporting by the measured employees themselves. Therefore, it is possible for an employee to manipulate his or her performance statistics by recording false production data. To guard against such manipulation, HAC's work measurement system policies require audits by production supervision, project management, and industrial engineering. We found that audits are not being performed regularly, and we noted a general distrust by HAC and Government personnel of the system's accuracy. An effective work measurement system must produce accurate, reliable information.

While an effective work measurement system can be a useful management tool, employees must have sufficient work to perform. We found two departments where work was not sufficient to keep employees busy. One supervisor stated that recent individual performance indexes were not a fair indication of employee abilities, and that their performance was poor because scheduled production did not require a full day's work. Further review disclosed that several departments were in a transition stage, with one project declining before another starts up. Such requirements changes should be anticipated and corresponding adjustments should be made to departmental staff levels to avoid overstaffing and productivity loss.

2. Recommendations. We recommend that HAC management:

a. require supervisors to exercise tighter control over subordinates' activities. Whenever possible, reassignments should be made so that supervisors can spend as much time as possible at or near their work stations.

b. improve the work measurement system and increase use of it to identify the potential for productivity increases.

Further, departmental staffing levels should be established in response to work requirements.

3. Contractor's Response. HAC generally concurred in the results of our review and has taken action to improve labor productivity. In addition, it has begun taking action to improve its work measurement system. See Exhibit A for HAC's complete response.

EXCERPTS FROM DCAA REPORT
ON ESTIMATING SYSTEM SURVEY FOLLOW-UP
OF TEXAS INSTRUMENTS, DALLAS, TEXAS

Report No. 1501-1D240.001 DTD. October 22, 1981

3. Summary of Findings and Recommendations.

a. Summary Evaluation on Overall Effectiveness of the Contractor's Estimating System. In our opinion, the contractor's estimating system contains several significant weaknesses which pose a high degree of risk in the evaluation and negotiation of Government contracts; in particular, on follow-on firm fixed price contracts. Our previous Audit Report No. 1501-9B240.001 dated 10 July 1979 cited numerous deficiencies and/or weaknesses in the contractor's estimating system. A number of reported deficiencies and/or weaknesses detailed in the previous report have been satisfactorily corrected by the contractor; however, some have not been corrected or little or no action has been made to resolve the basic issues cited. The most significant continuing area of concern deals with the contractor's cost accounting system and related data used as a basis for estimating product manufacturing labor costs on follow-on firm fixed price contracts.

b. Summary of Findings and Recommendations.

(1) Manufacturing Shop Labor - Rollup Run Cost. The contractor's cost accounting system is project oriented, i.e., a project generally contains a number of firm fixed price contracts for the same product. For estimating base manufacturing shop labor costs on initial pricing proposals, the contractor may prepare a "Rollup Run Cost" Report using a period of time he deems appropriate to estimate such labor costs. This report basically represents a "snapshot" or "slice" of experienced average labor costs for the product being proposed. The contractor may apply certain judgments to the selected cost history as well as factors for learning, quantity adjustment, production break, and escalation. The contractor contends that the "Rollup Run Cost" Report is an estimating technique not subject to certification as current, complete, and accurate cost or pricing data, and that the monthly microfiche (Detail Job Order Cost Report) submitted to DCAA constitutes his compliance with Public Law 87-653. The monthly microfiche represents some 40,000 pages of equivalent hard copy. A project may contain hundreds of work orders (parts) with a multiple of production releases. As such, it is virtually impossible for Government reviewers to determine the reasonableness of the average manufacturing labor (shop) cost as selected by the contractor for systems or lower level assemblies that may contain hundreds of parts and with production releases covering a sustained period of time. We believe that the entire data base upon which the contractor made his selection is cost or pricing data as well as facts dealing with future production plans. However, without benefit of a continuous and uninterrupted stream of average product labor cost history displayed in a usable format, it is most difficult for the Government reviewers to reasonably evaluate average unit cost trends for the product under consideration and within the time restraints allowed for field pricing reports. Accordingly, we recommend that the contractor, as part of his initial pricing proposal package, display on a summary type basis average manufacturing (shop) labor cost data (hours and dollars) along with equivalent production units by reasonable and consistent time increments, as derived from his complete historical data base associated with the product being proposed. Further, we recommend that this type summary data be continuously disclosed to appropriate Government negotiators up to final agreement on contract price. We also recommend that the contractor's complete cost or pricing data used as a basis to derive such average product labor trend data be clearly identified as part of the initial pricing proposal package for verification purposes. Additionally, we recommend that the contractor, as part of the initial pricing proposal package, clearly distinguish between that portion of base shop labor specifically based on factual data, and that portion based on judgmentally derived estimates. In order to appropriately determine the reasonableness of other cost factors applied or not applied by the contractor (learning, quantity adjustment, production break), we recommend that the contractor disclose available facts affecting the product under consideration such as data in support of futu production and procurement volume, changes in production methods, etc., which reasonably can be expected to contribute to sound estimates of future labor costs. (Page 10)

(2) Labor Cost Estimates Based on Manloading Technique. Generally, the contractor's supporting data for manloaded estimates

are considered inadequate as a basis for the DCASPRO Technical Analyst (TA) to determine the reasonableness of proposed manhours/manmonths (MH/MM) either quantitatively or qualitatively. Supporting data typically lacks justification for the types of proposed labor skills, and identification of specific tasks to be accomplished by each labor category under the proposed procurement. We recommend that the contractor develop and include in the Cost Estimating File appropriate backup data in support of estimates based on the manloading technique to include rationale for the types of labor skills proposed; description of duties to be performed by each skill level in such definitive terms as to reflect the quantitative level of effort required; and, support for the time period chosen for performance of the subtasks. (Page 16)

(3) Manufacturing Labor Scrap/Overage. The contractor, when using the "Rollup Run Cost" generally adds additional labor costs by use of a percentage factor for the purpose of covering potential losses occurring during higher levels of production. No verifiable cost or pricing data in support of the proposed percentage factor are furnished by the contractor relative to actual production losses that are experienced in the production process. In order to achieve sound pricing of Government contracts, the contractor should provide verifiable cost or pricing data reflective of actual losses sustained in the production process. In this regard, we recommend that the contractor (i) separately accumulate labor costs for such losses in the cost accounting records, or (ii) accumulate such labor costs in a manner so they may be extracted from the cost accounting records when needed in support of a factor, or (iii) devise an acceptable and consistently used methodology which will provide a relevant statistical measure of such losses sustained in the production process. (Page 19)

(4) Manufacturing Labor - Purchased End Items/Manufactured End Items. The contractor's cost accounting system does not provide cost visibility for manufacturing efforts associated with Purchased End Item (PEI) spares. PEIs are vendor purchased parts delivered as end items, and generally do not require any further processing by the contractor except for quality control, handling, tests, inspection and pack. These labor activities are accounted for under General Work Orders (GWO) in the contractor's cost accounting system. When developing program factors, total GWO labor costs are generally combined and related to a shop labor base (work orders). Accordingly, without segregation of GWO labor costs specifically identified to PEIs, estimated GWO costs on Manufactured End Items (MEI) tend to be over-estimated when based on historical cost or pricing data. We believe that the contractor's cost accounting system should effectively measure labor activities associated with PEIs and MEIs to be used as a basis for forecasting future costs. Accordingly, we recommend that the contractor establish in his cost accounting system specific GWO categories to collect the costs associated with PEI's. Such cost segregation would provide an appropriate measure of GWO labor cost activity to be used as a basis for estimating GWO labor costs on PEIs and MEIs. (Page 21)

(5) Identification of Subcontracts, and Related Pricing Data. The contractor's system (IMS) does not distinguish between an item that is a subcontract under the DD Form 633 definition, and other

categories of purchased materials. Further, a separate listing of subcontract items in excess of $100,000 is not generally produced along with required information on each proposed subcontract such as type, degree of competition, basis of establishing source and reasonableness of price, results and/or status of the contractor's review of the prospective subcontractor's cost and pricing data. Separate categorization of subcontracts, listing of proposed subcontracts in excess of $100,000, and information relative to the contractor's basis of establishing the type, source, and reasonableness of each subcontractor's proposed price are required under the DD Form 633 and DAR 3-807. In order to achieve sound pricing of the prime contract, this display of data as part of the initial pricing proposal package is necessary to permit the Government to decide at the "front-end" of the procurement process which subcontracts require further analysis by the contractor, or by further Government reviews of subcontractor's estimates at the subcontractor's plant. Accordingly, we recommend that the contractor provide the required subcontract data as a part of his initial proposal package. (Page 22)

(6) Verbal Vendor Quotations. The contractor, as a matter of policy, does not obtain confirmed vendor quotations in circumstances where he deems that established, qualified suppliers currently possess adequate data to allow pricing action. In our opinion, initial pricing proposals which contain a significant portion of priced Bill of Material (B/M) items that are based solely on verbal vendor quotations do not constitute submission of adequate cost or pricing data for sound negotiation of a contract price. Further, contractor internally generated documents in support of verbal vendor quotations do not constitute sufficient evidentiary matter for the auditor to express an informed opinion relative to the reasonableness of proposed unit prices when such prices are based solely on verbal vendor quotations. Where adequate purchase cost history is not available, we recommend that the contractor obtain from prospective vendors the best cost and pricing data available. This data should take the form of soliciting formal bids from prospective vendors for appropriate quantity ranges that are anticipated to be purchased from known and projected requirements. Under an understanding (AD HOC), expressed on 3 May 1978, "Texas Instruments will make an earnest effort to have verbal quotes confirmed and no older than 90 days at the time of proposal evaluation for these quotes in excess of $25,000 which are within the top 25 percent of the dollars in the Bill of Material." We believe this understanding is inappropriate in circumstances where (i) no recent purchase history exists; (ii) quantities substantially vary from past purchases; and, (iii) quoted unit prices vary substantially from unit prices on previous purchases. Under these conditions, we recommend that the contractor employ his formal bid request procedures to substantiate B/M unit prices. For more significant items, we recommend that the contractor perform necessary analyses that will establish a target price considered achievable in the negotiation of the price of such item under sole-source buy conditions. (Page 27)

(7) Material Scrap and Overage. The contractor's predominate method of estimating direct material requirements for initial pricing of firm fixed price contracts is the "Gross Material Method B."

This method entails use of the contractor's IMS System whereby a Bill of Material (B/M) report is produced based on net material requirements for the configured product. This report details by part number approximately 80 percent of the parts' value. The contractor, in most cases, judgmentally increases the net requirement of each part in the top 80 percent to provide for potential scrap/overage that occurs in the production process. No cost or pricing data are provided by the contractor to substantiate actual scrap/overage that is experienced in the production process for the proposed product. The contractor emphasizes detail pricing of the top 80 percent of B/M's because experience has indicated that generally 80 percent of the dollars evaluated in a B/M is associated with about 20 percent of the part numbers. The Government has not approved but also has not questioned the contractor's mechanical technique or philosophy of concentrating on pricing the top dollar value of B/M's and subsequent extrapolation to the 100 percent level. If the Government has been willing to take the risk of accepting detail pricing of the top 80 percent B/M and subsequent extrapolation to the 100 percent level, the contractor should have reasonable and sufficient documentation in support of additional direct material quantities over and above net requirements. Overall risk reduction to the respective contracting parties can be achieved by the contractor through development or use of existing records that will appropriately measure actual direct material losses that are associated with the top dollar value of B/M's. We recommend that the contractor implement a system that will consistently measure experienced direct material losses associated with the most significant B/M items, i.e., top 80 percent of B/M. Such a system should provide data that is verifiable through inspection of underlying documentation. Further, we recommend that the contractor submit or clearly identify such cost and pricing data concurrently with the initial pricing proposal along with appropriate explanations and/or rationale for judgments used or projections made from the experienced data. (Page 30)

(8) Material-2 Versus Fabrication Labor Costs. "Material-2" represents a category of material costs for fabricated parts normally manufactured in-house by the contractor. In circumstances where the contractor uses the "Rollup Run Cost" as a basis for estimating shop labor, an overestimation of cost occurs where the proposed subcontracted effort is also averaged in the "Rollup Run Cost." We recommend that the contractor review the historical data used as a basis for estimating base shop labor and make appropriate adjustments to such labor in consonance with his proposed subcontracting plan. (Page 34)

(9) Program Direct Cost Factors. On ongoing programs, the contractor may estimate certain elements of direct cost by use of factors. The contractor, as a matter of routine, does not record, identify, classify or screen costs associated with the historical data base relative to the nature of the activities involved, i.e., recurring, nonrecurring, or separately funded. Under these conditions, historical direct cost factors may not be representative of future costs under a given initial pricing proposal. The contractor does not provide quantifiable direct cost projections based on future program requirements (program budgets); accordingly, Government analysts

do not generally have a basis to determine the reasonableness of the contractor's judgment applied to historical direct cost factors. The contractor has extensive capability to classify incurred direct costs according to recurring and nonrecurring activities as well as accounting for separately priced contract line items through the existing "Project Order" and "Job Order" cost accounting structure. We believe that a lack of well defined written cost accounting procedures relative to direct cost classifications significantly contribute to this condition. We recommend that the contractor develop and consistently follow written cost accounting procedures which define activities according to their nature so they may be appropriately classified in the accounting records. Such procedures should provide that the accounting records visibly reflect or provide ready identification of nonrecurring, recurring costs as well as those costs associated with items separately or distinctly priced in contracts. We believe that a significant amount of time could be saved on the part of the contractor and the Government and a reduction to negotiation disputes could be achieved if an advanced agreement could be reached relative to the proper classification of costs in the historical data base. Further, we recommend that the contractor prepare trend data and project program direct cost factors based on quantifiable program budgets for known and anticipated future business within each program. Such a direction on the part of the contractor, in our opinion, could lead in the future to negotiations of Forward Pricing Rate Agreements (FPRA) covering direct cost factors. Negotiated FPRA's would mutually reduce Contractor/Government time on preparation and review of initial pricing proposals, speed up the cycle time, and reduce negotiation disputes. (Page 36)

4. Areas of Emphasis in the Review of Pricing Proposals. Based on the weaknesses enumerated in paragraph 3 above and detailed in Section B of this report, the following areas should be emphasized in the review of pricing proposals:

a. Direct Materials.

(1) Subcontracts. The reviewer should assure that a proper identification of subcontracts according to the DD Form 633 definition has been made along with disclosure of the contractor's source and reasonableness of price, and results and/or status of the contractor's review of the prospective subcontractor's cost and pricing data. This data needs to be obtained as early as possible in the procurement process so Government contracting officials can decide whether further analysis is warranted for sound pricing of the prime contract.

(2) Interorganizational Transfers at Other Than Cost. The reviewer should assure that proper disclosure of the pricing method used has been made by the contractor. When such items are not based on "adequate price competition", steps should be taken to obtain that data required under DAR 3-807(b)(2).

(3) Verbal Vendor Quotations. The contractor should be requested to furnish appropriate substantiating documentation for material items that are priced based on verbal vendor quotations.

Acceptance of verbal vendor quotations should be considered inappropriate in circumstances where (i) no recent purchase history exists; (ii) quantities substantially vary from past purchases; and (iii) quoted unit prices vary substantially from unit prices on previous purchases.

(4) Material Scrap and Overage. In the absence of verifiable cost and pricing data which reflects experienced losses in the production process, acceptability of such added material costs poses significant risk to the Government in the pricing of firm fixed price contracts. Use of industry guides may not be reflective of the losses sustained by the contractor.

(5) Material-2. A comparative review, by part number, should be made between individual material items and data used for estimating shop labor to assure that labor costs are appropriately adjusted to consider the condition of subcontracting for each part.

b. Direct Labor.

(1) Manufacturing Shop Labor - "Rollup Run Cost" Estimating Technique. For initial pricing proposals based on the "Rollup Run Cost", emphasis should be placed on obtaining average experienced product labor trend data in a usable and meaningful format as well as factual and quantifiable data regarding future production quantities and production methods. This data is considered necessary for a proper evaluation of proposed shop labor costs in terms of current labor trends as well as a meaningful consideration of the effects of learning and efficiencies gained through improved manufacturing methods, etc. However, as a matter of routine, the contractor does not display average experienced product labor costs (hours and dollars) along with equivalent production units by consistent and continuous increments of time. Accordingly, without benefit of such labor trend data, on a summary basis, it is and will continue to be most difficult for Government reviewers to evaluate and reasonably predict future manufacturing shop labor costs for the product under consideration.

(2) Labor Cost Estimates Based on Manloading Techniques. For extimates that are based on the manloading technique, emphasis should be placed on obtaining adequate rationale for the types of labor skills used, a description of the duties to be performed that reflects the quantitative level of effort required by each skill level, and support for the time period used (phasing). Available cost or pricing data relative to experienced historical costs, especially in the area of manufacturing engineering and sustaining engineering should be requested, analyzed, and compared to manloaded estimates.

(3) Manufacturing Labor - Scrap/Overage. In the absence of verifiable cost and pricing data, which reflects experienced losses in the production process, acceptability of such added labor costs poses significant risk to the Government in the pricing of firm fixed price contracts. Use of industry guides may not be reflective of the losses sustained by the contractor.

(4) Manufacturing Labor - Purchased End Items/Manufactured End Items. We recognize that certain labor efforts are associated with Purchased End Items (PEI). However, without cost segregation in the cost accounting records between efforts associated with PEIs and Manufactured End Items (systems and spares), the cost accounting system cannot effectively be used and sound estimates of future costs are difficult to achieve.

c. Program Direct Cost Factors. Historical cost accounting data used as a basis for future estimates may contain costs associated with nonrecurring activities or costs associated with efforts specifically priced into contracts. Accordingly, the contractor should be requested to identify such costs in the historical data base used to develop such factors. Further, available facts dealing with future production efforts should be requested in order to evaluate on a projected basis trends in such factors.

5. Concluding Remarks.

a. An exit conference was held with contractor representatives on 21 October 1981. Principal contractor representatives in attendance are as follows:

(DELETED)	Manager, Contract Services/Government Affairs
(DELETED)	Manager, Government Contracts
(DELETED)	Branch Manager, Contract Administration

b. The contractor's reactions to our recommendations were furnished in writing on 31 August 1981, and are included in this report under Appendix A.

c. We express our appreciation for the cooperation extended by the contractor to the team members in the performance of this survey.

d. A follow-up review is contemplated on the status of the contractor's implementation of the recommendations contained in this report. Appropriate supplemental reports will be issued as necessary.

e. Additional audit assistance in the implementation of the report recommendations will be provided upon request.

DEFENSE CONTRACT AUDIT AGENCY

Donald V. Landis
DONALD V. LANDIS
Resident Auditor

B. CONDITIONS REQUIRING CORRECTIVE ACTION AND RELATED RECOMMENDATIONS.

1. Manufacturing Shop Labor - Rollup Run Cost.

a. Condition.

The contractor's cost accounting system is project oriented. A project may include all firm fixed price contracts for the same product regardless of customer source (defense agencies, other Government agencies, commercial and foreign). Within the project, manufacturing shop labor is accumulated by individual "parts-oriented" work orders. These work orders collect direct labor costs as well as other direct costs associated with specific parts, i.e., a specific work order equates to a discrete part. As production progresses over time, releases are made to established work orders for quantities to satisfy existing contractual requirements.

In support of proposed base manufacturing shop labor on initial pricing proposals, the contractor may prepare a "Rollup Run Cost." This involves a number of reports. Because the "Rollup Run Cost" is primarily related to manufacturing shop labor, report descriptions below are oriented toward work orders.

Detail Job Order Cost Report.

The Detail Job Order Cost Report is an official accounting document. This report sorts all job orders into separate lists of engineering orders, work orders, tool orders, and general work orders. The report lists, for each work order, the part number and description, the open date and quantity, the labor and material close dates and quantities, and the costs for each element of cost associated with individual work order runs. This report, prepared on microfiche, is provided to DCAA on a monthly basis. The monthly produced Detail Job Order Cost Report displays cost information for the three most recent past months in both hours and dollars, and also the cumulative charges to date. Once a work order run has been completed, it is dropped from the current monthly Detail Job Order Cost Report after an elapsed period of approximately three months.

Job Order Unit Cost History.

This report summarizes by individual work order total costs incurred by functional categories of cost centers. Functional categories of cost centers consist of the following: engineering, fabrication, assembly, test, quality control, material, and other direct costs (these functional groupings are referred to as "fields"). For each field and each work order assigned to a cost center, the report details for each closed run the average unit cost of the item covered by the work order within the "time mode" selected by the contractor. The requestor (contractor) has the option of selecting this information by the following time modes: (1) all open runs, (2) all closed runs, (3) both (1) and (2), and (4) all runs closed within a designated period of time, (e.g., six months), and (5) the last run closed. A run consists of a single, continuous manufacturing release. For each work order, the Job Order Unit Cost History Report also contains the part number and description as described under the Detail Job Order Cost Report.

Average Unit Cost History Report.

This report contains the same information as the Job Order Unit Cost History Report but automatically averages the cost of all runs closed within the "time mode" selected by the contractor. This report is in part number sequence and is sometimes referred to as a "Posting Sheet" as the contractor may adjust average costs for errors and judgment before computer input to prepare the "Rollup Run Cost" Report.

BML Explosion (Xmas Tree).

This report serves as an index for work orders contained in Job Order Unit Cost History Reports and Average Unit Cost History Reports; it contains no cost information. The BML Explosion is a computerized Bill of Material listing in a Xmas Tree format for all manufactured parts. It sets forth each part by number and total quantity required for a deliverable end item. It also contains the work order made-on and used-on for manufactured parts.

Parts Run Cost Report.

This report contains a sequential listing of all part numbers currently required to make up the top level assembly, LRU, or system. For each part number, it displays the discrete labor cost of producing that part, segregated by functional fields. The cost to produce is derived from the Average Unit Cost History Report (Posting Sheet) and, therefore, is available in the same format and by the same time mode options.

Rollup Run Cost Report.

This report contains the same information as the Parts Run Cost Report except that, with respect to any particular part number, the cost to produce displayed consists of the cost of producing that part number and all lower level assemblies. The Rollup Run Cost Report is available in the same format and with the same time mode options as the Parts Run Cost Reports. The predominate selection of cost history used by the contractor to prepare the "Rollup Run Cost" Report is a six month period for work order runs that were closed within that time period although other periods varying in length may be selected.

The average labor costs derived from the "Rollup Run Cost" extended by the number of deliverable units becomes the contractor's starting manufacturing (shop) base labor amount proposed on initial pricing proposals when such method is used (usually on follow-on firm fixed price procurements). Factors that may be applied to base manufacturing (shop) labor to arrive at total shop labor costs (before application of program factors) include the following:

Learning
Quantity Adjustment
Production Break
Escalation

Government reviewers have continuously taken exception to the "Rollup Run Cost" for a variety of reasons. The primary exception taken to the contractor's use of the rollup method is that the contractor selects the time mode he deems appropriate to prepare such report. As discussed above, the contractor's cost accounting system is project (product) oriented; accordingly, because of the continuous nature of the production process under the project concept, the contractor's system may be thought of as being somewhat similar to a process accounting system, i.e., production costs are average cost relative to a given product and consequently to a given contract. In effect, the contractor's "Rollup Run Cost" basically represents a "snapshot" or "slice" of experienced average manufacturing labor costs which occurred for closed work during the time mode selected by the contractor. The rollup method does not display complete cost and pricing data for manufacturing shop labor upon which the contractor's time mode selection was made, nor are average product labor cost trends over a sustained and continuous period of time reflected by use of a "snapshot" or "slice" of cost history.

The contractor contends that the "Rollup Run Cost" is an estimating technique not subject to certification as current, complete, and accurate cost or pricing data as regulations exclude certification as to the accuracy of the contractor's judgment. Further, the contractor contends that the Detail Job Order Cost Report (microfiche) as furnished to DCAA on a monthly basis constitutes his submission of certifiable cost or pricing data. We agree that to the extent the contractor may make adjustments to historical averages based on judgments and which are fully disclosed as judgments are excludable from cost or pricing data certification; however, it is our opinion that the historical data base upon which the contractor's selection was made to prepare the "Rollup Run Cost" including that portion of the data base actually used is certifiable cost or pricing data, and such data base applicable to the product being proposed continues to be certifiable cost or pricing data up to final agreement on price for individual initial pricing proposals requiring such certification.

In regards to microfiche furnished DCAA, this monthly submission of cost accounting data represents some 40,000 pages of equivalent hard copy. Further, a project may contain hundreds of work orders with multiple production releases. As such, it is virtually impossible for Government reviewers to determine the reasonableness of the average manufacturing labor (shop) cost as selected by the contractor for systems or lower level assemblies that may contain hundreds of parts and with production releases covering a sustained period of time. Further, without benefit of a continuous and uninterrupted stream of average product labor cost history displayed in a usable format, it is most difficult to measure or determine the reasonableness of factors that may be judgmentally applied to base manufacturing labor cost such as learning, quantity adjustment, and production break.

Based on DAR 3-807.1(a)(1) and 3-807.3(c), cost or pricing data encompasses more than just providing cost accounting records to DCAA. Cost or pricing data consist of all facts which reasonably can be expected to contribute to sound estimates of future costs as well as to the validity of costs already incurred. It is information, being factual, that can be verified. Unit cost trends, such as those associated with labor efficiency, are cost or pricing data according to the DAR 3-807.1(a)(1) cost or pricing data definition.

b. Recommendation.

In our opinion, the Government should have at least an equal opportunity to review complete cost or pricing data to determine the reasonableness of the average labor cost as selected by the contractor for a given product as well as current labor averages being experienced for that product. However, because the contractor does not continuously and consistently display his complete cost and pricing data in the rollup or other usable format, it is virtually impossible for Government analysts to determine the reasonableness of the average labor costs derived from the contractor's selection period as a predictor of future labor costs for a given initial pricing proposal within the time restraints allowed for field pricing reports. Based on our observations, the contractor has extensive computer capability to display historical labor information in any format he desires. Accordingly, we recommend that the contractor, as part of his pricing proposal package, display on a summary type basis average manufacturing (shop) labor cost data (hours and dollars) along with equivalent production units by reasonable and consistent time increments, as derived from his complete historical data base associated with the product being proposed. Further, we recommend that this type summary data be continuously disclosed to appropriate Government negotiators up to final agreement on contract price. We also recommend that the contractor's complete cost or pricing data used as a basis to derive such average product labor trend data be clearly identified as part of the initial pricing proposal package for verification purposes. Additionally, we recommend that the contractor, as part of the initial pricing proposal package, clearly distinguish between that portion of base shop labor specifically based on factual data, and that portion based on judgmentally derived estimates.

In order to appropriately determine the reasonableness of other cost factors applied or not applied by the contractor (learning, quantity adjustment, production break), we recommend that the contractor disclose available facts affecting the product under consideration such as data in support of future production and procurement volume, changes in production methods, etc., which reasonably can be expected to contribute to sound estimates of future labor costs.

c. Contractor's Reaction.

The auditor indicates DCAA has continuously taken exception to use of run cost. This is incorrect. At a matter of fact, in some instances where another estimating technique was utilized, DCAA has requested that Rollup Run Cost be generated, even in some cases where the historical costs were, because of the nature of the contract, segregated for other costs and the incurred average cost per system produced was apparent. The auditor also comments that the contractor's judgment applicable to run cost is not evident. This also is incorrect. The AUCH (posting sheet) identifies the contractor's judgment and the portion based on factual data.

The general tone of the auditor's comments is that certain information concerning costs is available to the contractor, but not to the auditor. The contractor is very concerned that the casual reader will therefrom believe cost or pricing data is being withheld from the auditor. This is not correct. As the auditor indicates, DCAA is furnished monthly the contractor's Detailed Job Order Cost Report which provides the incurred detail costs, by month, for each cost account. The auditor indicates the format in which this is provided prohibits it from being usable and that the contractor can computer generate a summary on a continuous basis. First, such a summary is not an "automatic generation", but requires considerable review to remove errors and make corrections. A minimum of 45 days is required to accurately generate a new run cost. This fact has been explained to DCAA on many occasions. Second, the statement that the information furnished monthly is not usable is incorrect. The contractor is aware of many instances where DCAA has utilized this data to generate run cost up-dates. In a recent audit, for example, the contractor was informed by the auditor that he had prepared a new run cost for a product by updating an existing run cost with five additional months data involving additional closed runs on more than 200 part numbers, some with multiple runs closed resulting in the closed runs reviewed being around 500. The auditor also indicated this was accomplished in a two or three day period. This does not lend any validity to the statement contained herein that "...because the contractor does not continuously and consistently display his complete cost and pricing data in the rollup or other usable format, it is virtually impossible for Government analysts to determine the reasonableness of the "average labor costs derived from the contractor's selection period as a predictor of future labor costs for a given initial pricing proposal within the time restraints allowed for field pricing reports."

However, a caution concerning this activity is appropriate. It is to be noted, however, that while DCAA has the capability and capacity to generate a revised Rollup Run Cost in a relatively short period of time, to prepare a complete new Rollup Run Cost takes a significantly longer time. Some of the reasons are: (1) The parts structure must be completely reviewed to make sure there are not breaks, (2) zero or blank close parts are investigated, (3) if there are no closed runs an estimate must be made, (4) the rollup results are compared with other rollups for anomalies, etc.

The data provided to the Government is current, accurate and complete. The inference that the contractor has available information that he is not providing is incorrect. Available facts are provided.

The auditor's comments herein would lead the casual reader to believe all the contractors proposals utilize the run cost estimating technique. This is not correct. A review of proposals made over the six months ending 31 July 1981 indicates that approximately 35 percent of the estimates made involved the use of run cost. Also, these estimates represented only about 15 percent of the total dollar estimated in this period.

d. Rejoinder to Contractor's Reaction.

Public Law 87-653 was enacted for the primary purpose of assuring that both contracting parties, the Government as well as the contractor were knowledgeable of current, accurate and complete data whereas a reasonable contract price can be negotiated. For this to occur it would be necessary for the Government, as well as the contractor to have complete knowledge of the contractor's experience in the prior manufacturing processes. Historically this has not happened during negotiations with Texas Instruments, i.e., they support numerous price proposals with what is termed "run costs" which represent historical data coupled with judgment factors for a period they consider most representative. They do not choose to show the Government similar comparative data for other periods containing historical costs for the parts proposed whereas we can evaluate if the period(s) selected by the contractor do indeed represent its most representative time frames of manufacturing. While it is true the contractor, on a continuing basis, provides DCAA with history concerning manufacturing labor related to the detail parts, they do not furnish DCAA with history in a form that would allow comparison to amounts being proposed.

DAR 3-807.1(a)(1) states in part; "cost or pricing data embraces more than historical accounting data. It also includes ..., e.g., the comparative analysis by which a particular vendor was selected. In short, cost or pricing data consists of all facts which reasonably can be expected to contribute to sound estimates of future costs as well as to the validity of costs already incurred..." Irrespective of the aforementioned DAR requirement the contractor does not include rationale for selecting a period of performance which he deems most representative nor do they provide similar data for the other periods whereas the Government can evaluate if the period is or is not the most representative period.

DAR 3-807.3(c) states in part: "There is a clear distinction to be made between 'submitting' cost or pricing data and merely 'making available' books, records and other documents without identification. The latter does not constitute submission of cost or pricing data."

Irrespective of the DAR requirement the contractor continuously advises that the DAR requirement is met by merely furnishing detail parts history on a continuing basis. Supporting data for the submitted price proposals is not always updated to current actual experience occurring subsequent to the periods selected by the contractor as the most representative periods.

A severe detriment of the Rollup Run Cost estimating technique is that the calculations are made on labor dollars. Labor dollars do not give an indication of the labor necessary to perform a task. If the contractor used labor hours along with the dollars, both the contractor and the Government would be able to determine, with some accuracy, the reasonableness of the costs associated with time applied to the current dollars instead of going through a lengthy calculation to inflate prior years dollars into current years dollars and then projecting the dollars to future years dollars.

Another problem is our lack of knowledge about what skills of labor (labor mix) make up the proposed labor dollars. Problems may have been encountered on the runs used by the contractor to project follow-on work and higher than necessary skill levels may have been used. This would project incorrect dollars to the follow-on work. The contractor has the hours information in his accounting system and on occasion has presented hours only on run costs reports.

2. Labor Cost Estimates Based on Manloading Technique.

a. Condition.

Generally the contractor's supporting data for manloaded estimates are considered inadequate as a basis for the DCASPRO Technical Analyst (TA) to determine the reasonableness of proposed Manhours/Manmonths (MH/MM) either quantitatively or qualitatively. This is due to the fact that the supporting data typically lacks any justification for the types of proposed labor skills and usually fails to identify the specific tasks to be accomplished by each labor category under the proposed procurement.

We consider manloading to be a valid estimating technique when used in the proper circumstances. The manloading estimating technique is particularly useful in estimating the personnel resource requirements for efforts involving research or field service support. This technique develops the total estimated MH/MM for a task by dividing the task into subtasks, as necessary, and allocating varying levels of effort for appropriate labor skills to accomplish the subtasks over specified time periods. The essential elements of backup data in support of such estimates are (i) adequate rationale for the types of labor skills to be used; (ii) a description of duties to be performed by each skill in such definitive terms as to reflect the quantitative level of effort required; and (iii) support for the time period chosen for performance of the subtasks.

TI's use of manloading is deficient in that seldom is it supported properly; and/or it is not actually used to develop an estimate, but is a term TI uses occasionally to describe the spreading over time of the personnel resource requirements in MH/MM which have been derived by some other method.

In the majority of proposals submitted by TI, the proposed manufacturing and engineering labor costs based on manloading are proposed at the program level. In other cases, such as the IIS production program, a computer generated FP-5 is prepared in accordance with the reporting levels of a work breakdown structure.

The supporting data for TI's proposals included in the cost estimating file normally are limited to engineering estimating "green sheets." The green sheets usually encountered by the DCASPRO TA in evaluation of these proposals are for manufacturing engineering, sustaining engineering, and engineering labor for proposed data items. The green sheets for manufacturing and sustaining engineering are for the total effort with no further breakdown by specific manufacturing and sustaining engineering tasks or subtasks. There have been some cases where TI included in their proposals a listing of general tasks which the manufacturing and sustaining engineers generally perform. However, in such cases no specific amount of labor is ever associated with the specific tasks. Furthermore, TI does not indicate which tasks are applicable and will be performed on the subject procurement. In order to evaluate these efforts, the DCASPRO TA must judge which specific tasks are allocable for the proposed effort and what amount of labor is reasonably required to accomplish each task. This has been accomplished by varying degrees of success through interviews with the TI estimators. The success is dependent on the experience and cooperation of the TI estimator as well as the skill and experience of the DCASPRO interviewer. In any case, this approach is very time consuming for the TI estimator and the DCASPRO TA. When specific manloading figures have been questioned by the DCASPRO, TI has responded the labor was only roughly spread or "manloaded" after the proposed labor was derived from estimates by experienced TI personnel. Therefore, the contractor contends it is futile for the DCASPRO TA to challenge any part of the "manloading" since only the total labor figure proposed has any meaning.

b. Recommendation.

We recommend that the contractor develop and include in the Cost Estimating File appropriate backup data in support of estimates based on the manloading technique to include rationale for the types of labor skills proposed; description of duties to be performed by each skill level in such definitive terms as to reflect the quantitative level of effort required; and, support for the time period chosen for performance of the subtasks.

c. Contractor's Reaction.

We are very pleased that the auditor agrees that this is a valid technique for estimating costs. We also believe it is generally agreed that the contractor has, in accordance with AD HOC agreement 15, provided expanded support for manloading estimates. However, the adequacy of support is somewhat a subjective judgment and differences of opinion will continue to exist.

It is very important that one comment of the auditor be highlighted because of its importance. This is his comment that, during analysis of proposals using manloading techniques, "The success is dependent on the experience and cooperation of the TI estimator as well as the skill and experience of the DCASPRO interviewer." This experience requirement was pointed out by the contractor during the AD HOC discussions and also in the contractor's cost estimating manual. We believe if both parties are careful to utilize the proper level of personnel on these type proposals many problems can be eliminated. The contractor certainly recognizes the necessity of adequate discussion with the evaluator during his review. The contractor will re-emphasize this to those personnel who are involved in such discussions with DCASPRO. In conjunction with this, the contractor will be pleased to continue to work with DCASPRO in training personnel who are new to this office and, therefore, have not had the opportunity to become familiar with the contractor. As the auditor is aware, this has been done in the past. Also, we will be pleased, in conjunction with this activity, to continue to provide tours to aid in DCASPRO personnel becoming more familiar with our products and facilities.

d. Rejoinder to Contractor's Response.

Texas Instruments response to the specific deficiencies cited in the report is considered inadequate and inaccurate. TI's summary comment incorrectly states "Such data is included in the estimating file" but is subjective and therefore subject to disagreements as to its adequacy. As clearly stated in the report, the contractor's estimating file typically does not contain rationale which can be evaluated and explains the basis of, and need for, each labor category proposed, the particular (sub)tasks each labor category is proposed to accomplish, the specified manhours/manmonths proposed to accomplish these (sub)tasks, and the proposed time frames in which these (sub)tasks are to be accomplished. A green sheet depicting the spread of proposed manhours/manmonths over time for a total program level task shows what is being proposed but does not provide the necessary rationale which explains the basis of the proposal in the detail cited above. TI's Cost Estimating Manual, dated 1 August 1980, states in Chapter 5 that for engineering task/function manloading estimates rationale shall be recorded "for each functional staffing estimate covering the basic necessity of the function, the level of effort and the timing." This is not being accomplished as required to effect the improvements needed in this area of TI's estimating practices.

3. Manufacturing Labor Scrap/Overage.

a. Condition.

In circumstances where the contractor uses the "Rollup Run Cost" as a basis to estimate base manufacturing labor, a factor is applied to cover additional labor costs for potential scrappage of manufactured parts. The "Rollup Run Cost" automatically considers the effect of manufacturing labor lost in the production of individual parts; however, according to the contractor, it does not provide for manufacturing labor costs resulting from parts, subassemblies, and assemblies that may be scrapped for a variety of reasons during higher stages of production.

Our review of twenty-nine firm fixed price proposals indicated that such factor applied to base manufacturing labor ranged from five to fifteen percent. The discrete value for labor scrap/overage on these twenty-nine proposals amounted to $705,000. This discrete value becomes more significant, approximately seven times as much on the average, when loaded with other direct costs (GWO, Tooling, Manufacturing Engineering and Sustaining Engineering), and Indirect Cost Burdens. On TI Proposal No. 230-127-1488 dated 17 September 1980, for AN/AAS-36 Systems and Associated Items, the applied scrap/overage factor of 12 percent resulted in 8.1 percent being added to the proposed price as follows:

Proposed Scrap & Overage	
Direct Cost Loadings:	
GWO & Tooling	
Mfg. Engr.	
Sust. Engineering	(Dollar
Indirect Cost Loadings:	Amounts
Mfg. Overhead	Deleted)
Engr. Overhead	
G & A	
Cost of Money	
Subtotal	
Profit	
Total Effect at Price Line	
Proposed Contract Price (Item 1, 2, 3)	
Percent Scrap Loss Effect to Contract Price	8.1%

In all instances, the contractor did not provide any accounting, statistical, or other relevant cost data in support of the estimated factor. The contractor contends that no provision exists in the accounting system to routinely collect such costs in a cost effective manner; accordingly, such factor must be judgmentally estimated by project personnel familiar with the production process or product.

In our opinion, the contractor's use of a judgmentally derived estimate for a significant portion of manufacturing labor does not adequately afford the Government a reasonable basis to evaluate the costs for such potential losses. Sound pricing of mature products on a firm fixed price basis cannot be accomplished in the absence of verifiable cost and pricing data. As with material losses discussed in Section B, paragraph 7 below, the Government has to resort to its own judgment often using "rules of thumb" or industry guidelines which may or may not be indicative of the contractor's actual experienced losses. This office has recently issued a Cost Accounting Standard noncompliance report to the local DCASPRO ACO regarding this matter as it is our opinion that the contractor's estimating practice is not consistent with his cost accounting practices.

b. Recommendation.

In order to achieve sound pricing of Government contracts, the contractor should provide verifiable cost or pricing data reflective of actual losses sustained in the production process. In this regard, we recommend that the contractor (i) separately accumulate labor costs for such losses in the cost accounting records, or (ii) accumulate such labor costs in a manner so they may be extracted from the cost accounting records when needed in support of a factor, or (iii) devise an acceptable and consistently used methodology which will provide a relevant statistical measure of such losses sustained in the production process.

c. Contractor's Reaction.

The contractor's methodology discussed herein is a recognized technique for estimating labor scrap and overage. It is also a recognized fact that as parts and assemblies are "lost" in the downstream production cycle, this loss results in the associated fabrication and assembly costs being incurred with no fruitful benefit toward delivery of the end product. Also, the contractor is aware that reviewers are utilizing the same technique for providing the Government's estimate of labor scrap and overage. Although this is a recognized technique for estimating such costs, as an accommodation to the Government the contractor has discontinued the use of this estimating technique on all proposals which may result in CAS-covered contracts unless this portion of the estimate can be supported by analysis of actual costs.

The contractor will continue to search for a cost effective technique to accurately collect and report overage and scrap labor. If such a technique can be devised, the data will obviously be made available to the Government. In the meantime, it appears to the contractor that it would be more meaningful in comparing actual historical costs with proposed costs for the auditor to invest analysis effort in determining the reasonableness of total manufacturing labor rather than minute sub-elements such as labor overage and scrap utilized by the contractor in his effort to develop the proposed total manufacturing labor.

d. Rejoinder to Contractor's Response.

The contractor's comments are considered nonresponsive to the issue raised.

4. Manufacturing Labor - Purchased End Items/Manufactured End Items.

a. Condition.

The contractor's cost accounting system does not provide cost visibility for manufacturing efforts associated with Purchased End Item (PEI) spares. PEI spares are vendor purchased parts delivered as end items, and generally do not require any further processing by the contractor except for quality control, handling, test, inspection and pack. Labor costs associated with these efforts are collected in General Work Orders (GWO). A few GWO cost categories have been designated as spares related; however, the contractor states that historical costs specifically related to PEI's cannot be extracted from the cost accounting records.

When developing historical direct GWO cost factors, efforts associated with PEI's and Manufactured End Items (MEI) are combined and associated with a direct manufacturing shop labor base (work orders). This factor is generally used as a take-off basis for estimating GWO labor costs on MEI's.

During the period under review, the contractor used a factor to estimate manufacturing labor costs on proposals containing PEI spares (generally ten percent of adjusted material costs). It was our opinion that since the factor could not be measured through accumulated cost data, and because PEI and MEI GWO labor costs were combined in developing the MEI GWO labor factor, estimated costs on pricing actions tend to be overestimated when based on historical cost or pricing data. After a meeting on this matter in April 1980, the contractor began to use a manloading technique to estimate labor costs associated with PEI's. However, because cost segregation is not maintained in the cost accounting system, the measurement of GWO labor costs associated with MEI's will be clouded because of the lack of cost segregation, and the contractor's cost accounting system cannot be effectively used to measure those limited efforts associated with PEIs.

b. Recommendation.

We recommend that the contractor establish in his cost accounting system specific GWO categories to collect the costs associated with PEI's. Such cost segregation would provide an appropriate measure of GWO labor cost activity to be used as a basis for estimating GWO labor costs on PEI's and MEI's.

c. Contractor's Reaction.

The reviewer's statement that "When developing historical direct GWO cost factors, efforts associated with PEI's and Manufactured End Items (MEI) are combined..." is not correct. Those historical costs associated with PEI's and MEI's are collected in a common account from the point of incurrence. No attempt by the contractor was made to combine any costs. Those costs, under the contractor's present accounting system are not capable of being segregated (other than by allocation or laborious, arbitrary analysis). An example of this kind of cost is incoming inspection. The inspector, when inspecting the parts, has no idea of the end use of the parts. They are inspected and delivered to stock from whence they are issued for either or both PEI and MEI purposes. The contractor is not aware of any technique to accurately segregate such kinds of costs. The contractor would entertain any such technique of which the reviewer might be aware.

d. Rejoinder to Contractor's Response.

Common costs associated with PEI and MEI are charged to common GWO accounts and all costs are allocated to direct manufacturing labor by the use of factors. Therefore, proposing this type labor on any basis other than direct manufacturing labor will result in windfall profits accruing to the contractor. (The contractor on occasion proposes this type effort as a percentage of PEI material costs).

5. Identification of Subcontracts, and Related Pricing Data.

a. Condition.

Under the contractor's system, proposed direct materials are not categorized in accordance with instructions contained on the DD Form 633. The primary format used by the contractor in developing material estimates is the computer produced IM5 Bill of Material (B/M). The IM5 system accesses the manufacturing data base for the hardware structure ("Xmas Tree"), and keys to parts designated "P" for parts that are purchased. The IM5 printout does contain a significant amount of useful information as outlined below:

IM5 Contents

Part numbers in numerical order.

Actual purchase order description in the case of data from the purchase history, or description, comment, setup and tooling information from the quote file.

Vendor name.

Vendor code information - when an item has always been purchased from an outside vendor, a numerical "1" is shown. If procurement has always been made by interdivisional transfer within Texas Instruments, a numerical "2" is shown. A "3" is shown when both inside and outside purchases have been made.

Alpha characters denoting source of data such as "M" for MCS average, "E" for estimate in absence of MCS data. "P" indicates actual purchase order and "Q" denotes quotation.

Alpha characters "N" and "Y" denoting a distributor flow down on an option agreement.

Indicates releases made against agreements. A four (4) digit number identifies an option agreement and a six (6) or seven (7) digit number denotes a release against a blanket order or a purchase order option. A vendor's part number may also be shown from quote file.

Shows the date of either the purchase order or the quotation as applicable.

The selection code used by the buyer on purchase orders. In the case of quotations the lead time in weeks is shown.

Shows quantity - either as a range or discrete as appropriate.

Unit price.

Unit of measure associated with price "XX" is used to denote debit memos issued in conjunction with material returned to vendor.

Displays quantity of subject part number required for the given bid.

Unit measure of requirements.

Indicates the rank of the item from the original cost percentage array.

Vendor Type Code:

L = Large Business, employees greater than 500.
S = Small Business, employees less than 500.
D = Divisions of TI.

As discussed in Section B, paragraph 7 below, the net quantities on the IM5 report are manually adjusted for estimated additional material usage (scrap/overage), and generally priced-out using purchase/quote history reflected on the IM5 or other data. After extrapolation to the 100 percent B/M level, other direct material cost items are added such as Inflation, General Work Order, Engineering, and Tooling Material. Total material cost derived from the IM5 System plus adders is then reflected on the DD Form 633 summary under a category designated as purchased parts.

In our opinion, significant improvements to the contractor's estimating system can be achieved if materials are categorized along with appropriate needed information in accordance with the definitions and instructions contained on the DD Form 633, in particular subcontracted items. Special attention must be given to subcontracts as required under DAR 3-807.

According to the DD Form 633 definition, subcontracted items are parts, components, assemblies and services to be produced or performed by other than the contractor in accordance with the contractor's design, specifications or directions and applicable only to the prime contract. Further DD Form 633 requirements provide that "For each subcontract over $100,000, the support should provide a listing of source, item, quantity, price, type of subcontract, degree of competition and basis of establishing source and reasonableness of price, as well as the results of review and evaluation of subcontractor proposals when required by DAR 3-807." Specifically, DAR 3-807.4 states that "any contractor who is required to submit and certify cost or pricing data shall be required to submit accurate, complete and current cost or pricing data from prospective subcontractors in support of each subcontract cost estimate included in the contractor's submission. This submission shall be required whenever the Contracting Officer considers such subcontractor data necessary for pricing the prime contract, or, in any event, whenever such subcontractor cost estimate is either (i) $1,000,000 or more, or (ii) both more than $100,000 and more than 10 percent of the prime contractor's proposed contract price." The above requirements may be waived by the Contracting Officer under circumstances where the contractor can appropriately demonstrate to the satisfaction of the Contracting Officer that a prospective subcontract will be based on adequate price competition, or other described conditions. Other key requirements contained in DAR 3-807 are that the contractor shall be required to support subcontract cost estimates below the minimum mentioned above by any data or information needed to establish a reasonable contract price (DAR 3-807.4(d)), and that it is the responsibility of the contractor to review and evaluate subcontract proposals and related supporting cost and pricing data and furnish the results of such reviews and evaluation to the Government as part of their cost or pricing data submission (DAR 3-807.4(f)).

Under the contractor's IM5 system briefly described above, adequate information is not presented as part of the contractor's proposal package relative to the following:

(1) Individual B/M line items (part numbers) are not defined or designated in terms of DD Form 633 definitions, i.e., the IM5 System does not distinguish between an item that is a subcontract under the DD Form 633 definition, and other categories of purchased material.

(2) A separate listing of subcontract items in excess of $100,000 is not produced along with required information on each proposed subcontract such as type, degree of competition, basis of establishing source and reasonableness of price, results and/or status of the contractor's review of the prospective subcontractor's cost and pricing data.

Based on our review of the contractor's written procedures, it is apparent that the contractor generally emphasizes for expected sole source buys in the proposal stage the following:

Equipment Group Operating Instruction 1-5

> "...during TI's proposal stage, if the suppliers proposal is greater than 1) $1,000,000 or 2) $100,000 or 10% of TI's proposal, which ever is greater, per ASPR 3-807.3(b)(1), then a DD Form 633 and supporting data shall be requested for the probable buy quantity."

Cost Estimating Manual

> "For those appropriate subcontracts in excess of $100,000, DD Forms 633 and supporting documentation will be requested from the vendor and an effort will be made to have such documentation within 30 days. When available, this documentation will be provided for review. Reports of assist audits will be provided if available."

AD HOC Agreement (5/3/78)

> "In vendor solicitations issued by Texas Instruments for procurements of a non-competitive, non-commercial nature expected to exceed $100,000, Texas Instruments will increase its efforts to secure the submission of a DD Form 633 within 30 days."

In our opinion, during the proposal stage, the requirements of DAR 3-807 go beyond the mere obtaining of a DD Form 633 or quotation from a prospective subcontractor. More significantly, the DAR requirements specify that the reasonableness of the prospective subcontractor's price needs to be established for achieving sound negotiations of the prime contract. Accordingly, a prominent display of B/M items in excess of $100,000 representing subcontracts needs to be prepared in order for the Government to determine at the "front-end" of the procurement process those subcontracts requiring further analysis by the contractor or by further reviews at the subcontractor's plant. For instance, on TI Proposal No. 230-137-548 dated 12 November 1979, one IMS B/M item amounted to $422,233 for High Pressure Reservoirs (P/N 306209-1). Based on the audit review, such item was basically a sole-source buy item even though the contractor was attempting to qualify other suppliers for this item. The proposed subcontract unit price was based on a verbal vendor quotation. Based on advice of the auditor, an assist audit was obtained after receipt of the subcontractor's DD Form 633 dated 31 January 1980. Negotiations of the prime contract were delayed until receipt of the assist audit report, and evaluations of the subcontractor's proposed price were completed by Texas Instruments Incorporated. An overall reduction to the subcontractor's proposed price was achieved by the contractor which reduced material costs on the referenced proposal by $54,745.

b. Recommendation.

Separate categorization of subcontracts, listing of proposed subcontracts in excess of $100,000, and information relative to the contractor's basis of establishing the type, source, and reasonableness of each subcontractor's proposed price are required under the DD Form 633, and DAR 3-807. In order to achieve sound pricing of the prime contract, this display of data as part of the initial pricing proposal package is necessary to permit the Government to decide at the "front-end" of the procurement process which subcontracts require further analysis by the contractor, or by further Government reviews of subcontractors' estimates at the subcontractor's plant. Accordingly, we recommend that the contractor provide the required subcontract data as a part of his initial proposal package.

c. Contractor's Reaction.

The contractor is very concerned that this report included these type comments concerning material support. The methodology utilized by the contractor results from many years of coordination with Government representatives. The way costs are shown on the DD Form 633 was reviewed in the mid 1970's and was deemed in compliance with the applicable requirements. Also, during the joint AD HOC review in 1978 the contractor's material presentation format and information used in proposals was reviewed in detail and the computer generated format currently utilized was deemed satisfactory to DCASPRO, DCAA and the various procurement agencies represented.

Specifically, the previous reviews have determined that the formating used by the contractor fulfills the requirements of the DD Form 633. Also, the statement that a listing of proposed subcontracts in excess of $100,000 is not provided is not correct. The contractor automatically furnishes with each computer generated Bill of Material a rank order listing of part numbers by extended dollar value, which clearly shows those that are expected to be in excess of this amount.

As was discussed during the time of the AD HOC agreements the contractor is making an effort to obtain DD Forms 633 from prospective subcontractors where appropriate. It is correct that on occasions these are not available at the time of audit. They are provided to the auditor or the procuring agency when obtained, whichever is appropriate at the time of receipt.

In summary, the contractor is complying with the detail AD HOC agreements made concerning material costing. We are not aware of any serious concerns by procurement agencies regarding the adequacy of the computer generated Bills of Material routinely provided.

d. Rejoinder to Contractor's Response.

The contractor generally makes no effort to identify subcontract costs. On occasion, when required specifically by the procurement activity, the contractor has identified, and given more detail on, large subcontracts. The computer generated Bills of Material (IM5) are fine, as far as they go, but they do not always specifically identify subcontract items.

We suggest that procurement activities require the contractor to specifically identify subcontracts on a separate schedule, and submit supporting data with each proposal as required by DAR.

6. Verbal Vendor Quotations.

a. Condition.

Excerpts from the contractor's internal written procedures relative to verbal vendor quotations are presented below:

> Cost Estimating Manual
>
> "Verbal requests for quotations will be utilized when the analyst deems that the established, qualified suppliers currently possess adequate data to allow pricing action. Discretion must be used regarding requests for written confirmation of verbal price quotation as such action can result in increased administrative cost for the vendor and Texas Instruments, and ultimately to our customers."
>
> Operating Instruction No. 1-4
>
> "Verbal requests for quotations should be utilized when the (analyst) deems that the established, qualified suppliers currently possess adequate data to allow pricing action. Indiscriminate requests for written confirmations to verbal price quotations can contribute to increased administrative and clerical costs both to the vendor and Texas Instruments, therefore the analyst will use judgment in making such requests."

In our opinion, initial pricing proposals to the Government which contain a significant portion of priced Bill of Material (B/M) items that are based solely on verbal vendor quotations do not constitute submission of adequate cost or pricing data for sound negotiation of contract prices. Further, the use of internally generated documents purporting to be the results of verbal vendor quotations does not, in our opinion, constitute sufficient evidentiary matter for the auditor to express an informed opinion relative to the reasonableness of proposed unit prices when such prices are based solely on verbal vendor quotations.

For the purposes of this report, we examined several proposals containing B/M's with a significant portion of material unit prices that were based on verbal vendor quotations. This examination was made to determine whether there were any significant variances between quoted unit prices and actual unit prices paid to the vendor. Although we found a number of cases involving the significant use of verbal vendor quotations, only two cases are presented in this report for the purpose of substantiating our opinion, and to provide appropriate recommendations for improvements in pricing and negotiating Government contracts.

Under Contract No. F19628-77-C-0126 (TIPI), the contractor was authorized to proceed relative to Provisioned Item Spares as follows:

Contract Mod. No.	Mod. Date	TI Proposal No.	Proposal Date
PM0052	4 May 1979	230-122-1038	17 January 1980
PM0064	15 August 1979	230-122-1028	17 December 1979

Proposals were submitted by the contractor to definitize contract prices on the dates indicated above, and each proposal contained the same deliverable end items (purchased end items) with the exception of two items on Modification No. PM0052. Unit base material pricing for each item was based solely on nonconfirmed vendor quotations, and no other purchase cost history was available to determine the reasonableness of the quoted prices. Data submitted by the contractor in support of the unit prices for both proposals consisted of handwritten information on a TI Form designated as "Vendor Quotes", which contained the following:

Vendor Part Number	Description	Vendor Quote Date	Quantity Range	Quoted Unit Price
3066054-1	Power Supply	11/2/79	7-13	(DOLLAR AMOUNTS DELETED)
3066056-1	Vert. Sync. Assy.	11/2/79	7-13	
3066060-1	Horizonal Assy.	11/2/79	7-13	
3066064-1	Video Assy.	11/2/79	7-13	
3066068-1	LVPS Assy.	11/2/79	7-13	

A comparison of actual prices paid to the vendor versus the quoted unit prices is presented below:

Vendor Part Number	Deliverable Quantity Mod. PM0052	 Mod. PM0064	 Combined	Proposed Unit Price	Unit Price Paid	Variance	Percen Varian
3066054-1	13	7	20				54.7%
3066056-1	13	7	20				47.6%
3066060-1	13	7	20	DOLLAR AMOUNTS DELETED			50.2%
3066064-1	13	7	20				69.1%
3066068-1	13	7	20				50.5%

We did not determine the causes for the significant variances above; however, we do note that the combined quantities exceed the quantities contained on the "Vendor Quotes" which may have activated a price quantity break for each item.

b. Recommendation.

Where adequate purchase cost history is not available, we recommend that the contractor obtain from prospective vendors the best cost and pricing data available. This data should take the form of soliciting formal bids from prospective vendors for appropriate quantity ranges that are anticipated to be purchased from known and projected requirements. Under an understanding (AD HOC), expressed on 3 May 1978, "Texas Instruments will make an earnest effort to have verbal quotes confirmed and no older than 90 days at the time of proposal evaluation for these quotes in excess of $25,000 which are within the top 25 percent of the dollars in the Bill of Material." We believe this understanding is inappropriate in circumstances where (i) no recent purchase history exists; (ii) quantities substantially vary from past purchases; and, (iii) quoted unit prices vary substantially from unit prices on previous purchases. Under these conditions, we recommend that the contractor employ his formal bid request procedures to substantiate B/M unit prices. For significant items, we recommend that the contractor perform those analyses required to establish the reasonableness of quoted prices under sole-source buy conditions (see paragraph 5 above).

c. Contractor's Reaction.

The auditor apparently believes that verbal quotes are not valid and usable quotations. This belief is not understood by the contractor. The use of verbal quotations is an accurate and economical technique to obtain vendor pricing information on a timely basis without either the vendor or the contractor incurring undue costs. The auditor uses an example that purports to support his position that use of verbal quotes leads to inaccuracies. The facts of this example are given below.

The five items listed by the auditor as being verbal quotes were, in fact, confirmed in writing by the vendor on 2 November 1979. Both order PM0052 and order PM0064 requested short delivery times. Due to these short lead time requirements, Texas Instruments requested the vendor to submit a quotation with the shortest possible lead time. The initial quotation received was based on an expedited delivery of 150 days. After reviewing the initially quoted prices and discussing them with the vendor, the contractor requested the vendor to resubmit its quotation based upon a combined quantity of 20 units and a longer lead time. This new quotation resulted in substantially lower quoted prices for the items. The amounts quoted as compared to the prices paid are:

Part Number	Proposed Price	Purchase Price	Variance
3066054-1			4.1%
3066056-1			5.2%
3066060-1	(DOLLAR AMOUNTS DELETED)		6.4%
3066064-1			1.4%
3066068-1			6.1%

We believe the auditors comments are a distortion of facts. The facts support that the contractor obtained from the vendor the best cost and pricing information available, all factors considered. It is also important to note that all the above information was available prior to negotiations and was provided to the Government negotiator before agreement on price.

The use of verbal quotations is in compliance with the AD HOC agreements made with DCAA, DCASPRO and the various Government procurement agencies involved in the AD HOC review of the contractor's estimating system. We are disappointed at this distortion of facts in an attempt to change these agreements. The contractor plans to continue to comply with the AD HOC agreements.

d. Rejoinder to Contractor's Reaction.

We still contend that this contractor's use of verbal quotes leads to serious inaccuracies. The contractor has presented a misleading schedule on the same parts as used by the auditor. The contractor updated the prices before negotiation which resulted in lower prices to the Government. This would be fine if we could assure ourselves that the contractor would do the same thing on every negotiation. However, this is not always the case. In a recent negotiation, where an auditor was present, the contractor referred to the AD HOC agreement as negating any necessity for any updating of verbal quotes. That proposal had substantially more base material dollars proposed than the ones in our example. What makes this problem even more significant is the "add ons" to base material on each contractor proposal. The contractor proposed, for the five parts in the example, a total base material of $155,042. When we look at the prices the contractor paid for the five items, we find he paid $69,820. This is a difference of $85,222 before the "add ons." We consider a 55 percent reduction to be significant. Therein lies our problem with the acceptance of verbal vendor quotes. This contractor makes wholesale use of verbal vendor quotes. Some proposals are based almost 100 percent on verbal vendor quotes. We do not believe that the best interests of the Government are served by the acceptance, without question, of verbal vendor quotes. We suggest Government negotiators ask for updated vendor quotes at the time of negotiation.

7. Material, Scrap and Overage.

a. Condition.

Prior to 1978, in estimating the cost of direct material requirements, the contractor applied an unsupported scrap/overage percentage factor to base (net) material costs and certain other direct material cost loadings. This office, under provisions of Cost Accounting Standard (CAS) 401, appropriately reported that the contractor's use of a percentage factor not supported by accounting, statistical, or other relevant data from past experience, nor by a program to accumulate actual costs for comparison to such percentage estimates, was an estimating practice not consistent with his cost accounting practice. To alleviate possible noncompliant conditions, the contractor devised several methods for estimating material scrap/ overage as follows:

Run Cost Material: This method can be used for projects having a stable structure and a constant production rate. The technique proposes a gross Bill of Material (B/M) based on the unit material cost accumulated in an historic Rollup Run Cost. Additional allowance is made for scrap of manufactured parts/assemblies which have been delivered out of the making work order.

Gross Material Method A: This method can be used for projects chiefly of an engineering nature where precise material definition is often impossible. Material cost is estimated at the gross level even though a few purchased items may be identifiable; however, because so much material is not identifiable, it is impracticel to create a partial B/M with an adder for unknown material cost.

Gross Material Method B: This method involves starting from a net B/M for the job. Each purchased item on the B/M is adjusted to a gross level prior to pricing the B/M.

Bare Method: This method may be used in circumstances where the B/M is small compared to other cost elements of the proposal. No direct consideration for scrap/overage is included in material costs; however, a higher fee/profit is requested.

Principal Item Method: This method is similar to the Gross Material Method B and can be used for partially defined B/M's where at least 80 percent of the value of the expected material cost can be identified to parts.

Percentage Estimate: This method entails use of a scrap/ overage percentage factor applied to the priced net B/M where such factor can be supported from an historical cost analysis.

By far, since 1978, the predominate method (approximately 80 percent of the time) used by the contractor to estimate direct material requirements for initial pricing of firm fixed price contracts is the "Gross Material Method B." Under the contractor's computerized system, an IM5 report (Bill of Material Estimate - Purchased Parts) is produced using the existing manufacturing data base and purchasing quote history file. This report usually details by part number approximately 80 percent of the initial value of the B/M for purchased items. The initial value of the B/M is determined through use of the moving average unit prices (MCS average) at the print date of the report. The IM5 consolidates multiple used parts and prints the net quantity requirement for each part. The contractor, in most cases, judgmentally increases the net requirement of each part number in the top 80 percent B/M to provide for additional material usage that may occur from any of the following causes:

Operator error.

Quality control rejection at the piece part or assembly level.

Part losses during parts burn-in and parts conditioning.

Damage or destruction caused in material handling.

Pilfering.

Change in design.

Parts lost during fabrication and assembly.

Part losses during system acceptance and burn-in.

After gross requirements are determined, the top 80 percent B/M is priced. Based on the ratio of the extended dollars (gross quantities times updated unit prices) to the initial extended dollars (net quantities times MCS unit prices), the 80 percent B/M is extrapolated to the 100 percent B/M. Our analysis of the same proposal for AN/AAS-36 Systems and Associated Items referenced in paragraph B.3.a. indicated that the effect of additional quantities of material added $298,958 to net B/M costs applicable to the unique portion of the proposal. The effective percentage of additional material quantities was 11.3 percent of net material costs. When the costs of additional material (scrap/overage) are loaded with applicable direct and indirect cost loadings and profit, the overall impact of unsupported additional material costs added $515,341 to the proposed price for this one proposal. A review of 27 other proposals indicated that unsupported additional quantities of material amounted to $1.8 million being added to net B/M costs. The added costs represents a composite percentage of 10.3 percent being applied to net B/M material costs.

In our opinion, the contractor's use of pure judgment as a basis to increase net material quantities does not adequately afford the Government a reasonable basis to evaluate such potential losses for sound pricing of firm fixed price contracts. The lack of contractor submitted cost and pricing data which details relevant experienced material losses causes an inordinate expenditure of time and effort on the part of Government to make an independent evaluation and subsequent judgment of such material quantities. Such evaluations usually take the form of resorting to "rules of thumb" or use of industry guidelines as published by Fred C. Hartmeyer (Electronics Industry Cost Estimating Data). These guidelines or "rules of thumb" may or may not be reflective of the contractor's actual experienced losses. Further, in cases where there are large material allowances proposed for such materials as H-Film and 1173 glass, the contractor does not provide the Government technical evaluators access to shop records claiming such data are proprietary to the contractor.

b. Recommendation.

The contractor emphasizes detail pricing of the top 80 percent of B/M's because experience has indicated that generally 80 percent of the dollars evaluated in a B/M is associated with about 20 percent of the part numbers. The Government has not approved but also has not questioned the contractor's mechanical technique or philosophy of concentrating on pricing the top dollar value of B/M's and subsequent extrapolation to the 100 percent level. We believe that if the Government has been willing to take the risk of accepting detail pricing of the top 80 percent B/M and subsequent extrapolation to the 100 percent level, the contractor should have reasonable and sufficient documentation in support of additional direct material quantities over and above net requirements. Overall risk reduction to the respective contracting parties can be achieved by the contractor through development or use of existing records that will appropriately measure actual direct material losses that are associated with the top dollar value of B/M's. We recommend that the contractor implement a system that will consistently measure experienced direct material losses associated with the most significant B/M items. Such a system should provide data that is verifiable through inspection of underlying documentation. Further, we recommend that the contractor submit such cost and pricing data concurrently with the initial pricing proposal along with appropriate explanations and/or rationale for judgments used or projections made from the experienced data.

c. Contractor's Reaction.

The auditor indicates the contractor uses the top 80 percent of the Bill of Material to project material costs and that this results in the Government accepting some unusual and unshared risk.

As has been reviewed on many occasions, including during the AD HOC review, the contractor's computer generated Bill of Material utilizes a technique of pricing the top 80 percent of the material items, comparing this new and current pricing to the Material Costing System (MCS) average, and adjusting the total 100 percent MCS average by the adjustment found appropriate for the top 80 percent of the material items. This technique has been reviewed in detail by the Government, is considered adequate for projecting material costs for the total Bill of Material, and has been utilized for several years with no expressed concern by the Government. Any risks associated therewith are certainly no greater to the Government than to the contractor.

Also, the "facts" described are incorrect. The computer generated Bill of Material provided by the contractor includes a sample of the bottom 20 percent of the Bill of Material. DCAA routinely reviews a sample of these bottom 20 percent Bill of Material items and incorporates their findings on these into their audit recommendations. In view of this, the contractor does not understand the auditor's comments since DCAA does not rely on the results of the top 80 percent material items review to recommend their total costing recommendations. They also review a sample of the bottom 20 percent and include this in their recommendation. Where is the risk?

The recommendation that the contractor establish some method of determining scrap and overage on the "top dollar value of B/M's" would result in essentially all material items being included since items in the "bottom" on some Bills of Material will be in the "top" of Bills of Material for other proposals. Also, we are not aware of the "existing records" the auditor states are available for this purpose. Perhaps the auditor can identify these records to the contractor.

During the AD HOC review of the contractor's estimating system the currently utilized methods of estimating overage and scrap were discussed and recognized as the methods the contractor will utilize in estimating costs. The contractor plans to continue to conform with these agreements.

d. Rejoinder to Contractor's Response.

TI's response to specific deficiencies cited in the report is considered inadequate. For example, TI did not address some specifics, such as refusing access to shop records on some material types since TI considers this data proprietary. Also, TI did not address the inordinate expenditure of time and effort now required on the part of the Government to make an independent evaluation which can then be compared to the contractor's estimate. It is obvious that the Government cannot readily evaluate TI's typical, brief, and generalized statement that proposed material overages were simply based on engineering judgment. This method also lends itself to inconsistencies in proposed overages for identical materials besides being time consuming for both parties. It is noteworthy that, while TI rejects the recommended corrective action as too costly, the contractor offers no alternative methods which might tend to ameliorate the estimating deficiencies cited in the report.

8. Material-2 Versus Fabrication Labor Costs.

a. Condition.

The contractor has been proposing a category of material cost designated as "Material-2." This category of material represents effort to be subcontracted-out for fabricated parts normally manufactured in-house by the contractor. In circumstances where the contractor uses the "Rollup Run Cost" as a basis for estimating shop labor, an overestimation of cost occurs where the proposed subcontracted effort is also averaged in the "Rollup Run Cost" or other labor submissions.

For example, two recent Digital Scan Converter Group (DSCG) proposals examined by this office indicated that the contractor did not remove inappropriate labor costs for specific parts proposed as "Material-2." Our analysis indicated that the effect of this condition added approximately 4.7 percent to the proposed price of each contract as summarized below:

TI Proposal No. and Date	Proposed Contract Price	Material-2 at Price Line	Overestimated Shop Labor at Price Line	Percent Shop Labor to Contract Price
230-41-7779 (12/1/80)				4.7%
230-41-7845 (12/11/80)		DOLLAR AMOUNTS DELETED		4.7%
Total			______	4.7%

As discussed in Section B, paragraph 1.a. above, the underlying historical production report used for preparation of the "Rollup Run Cost" is the Job Order Unit Cost History (JOUCH) Report. This report contains the experienced average labor cost history for closed manufacturing runs under each work order/part number for the time mode selected by the contractor. Average unit labor cost (weighted for all closed manufacturing runs included in the JOUCH) for each part is then reflected in the Average Unit Cost History (AUCH) Report and ultimately included in the "Rollup Run Cost" either adjusted or unadjusted. The following are examples where in-house manufacturing costs were averaged in the preparation of the contractor's "Rollup Run Cost" for the same parts proposed as "Material-2" for the DSCG proposals referenced above.

		Unit Costs				
			Fabrication Labor			
Part No.	Description	Proposed Material-2	Make Runs	Buy Runs	Averaged	Over-Estimated Labor
875591-1	Support Yoke					$ 2.74
878247-1	Support Yoke	DOLLAR AMOUNTS DELETED				6.61
878294-1	Panel Front					51.06

*Later cost accounting data (closed manufacturing runs) indicated that average labor costs of $7.61 were incurred for additional in-house labor over and above subcontracted costs.

Because the JOUCH/AUCH averaged all the closed manufacturing runs, i.e., runs that represented solely in-house effort with runs that represented primarily subcontracted effort, the fabrication effort was skewed-upward as demonstrated below:

(Please see next page)

Average Unit Labor Costs

		Make Runs		Buy Runs		Averaged	
Part No.	Run No.	Closed Qty.	Average Labor Costs	Closed Qty.	Average Labor Costs	Closed Qty.	Average Labor Costs
875591-1	17		$	98	$ 1.90	98	$ 1.90
875591-1	18	96	7.42			96	7.42
Total		96	$ 7.42	98	$ 1.90	194	$ 4.64
878247-1	13			35	$ 2.56	35	$ 2.56
878247-1	14	28	$14.19			28	14.19
878247-1	15	21	13.44			21	13.44
Total		49	$13.87	35	$ 2.56	84	$ 9.17
878294-1	21	20	$77.10			20	$77.10
878294-1	22	22	27.38			22	27.38
Total		42	$51.06			42	$51.06

The difference between the averaged run costs (make and buy) and the buy costs is considered that labor which is overestimated when fabrication efforts for the part are proposed as "Material-2" (subcontracted effort).

b. Recommendation.

We recommend that the contractor review the historical data used as a basis for estimating base shop labor and make appropriate adjustments to such labor in consonance with his proposed subcontracting plan.

c. Contractor's Reaction.

It is interesting to note that your recommendation in this area coincides exactly with our long standing practice, therefore, we concur. It should be further noted that the example cited was a random human error that was discovered and corrected during negotiations of the proposals.

9. Program Direct Cost Factors.

a. Condition.

On ongoing programs, the contractor may estimate certain elements of direct cost by use of factors. A summary of the categories of such factors that may be used is presented below:

Direct Labor Factors

General Work Order Labor
Tooling Labor
Sustaining Engineering Labor
Manufacturing Engineering Labor

Direct Material Factors

General Work Order Material
Tooling Material
Engineering Material

Other Direct Cost

Travel
Computer
Interdivisional at Cost

In the development of such factors listed above, the contractor provides a factor package which presents direct cost relationships as derived from historical cost accounting data, usually for a recent one-year period. On individual initial pricing proposals, the contractor may propose the derived historical factors, or judge such derived factors up or down depending upon the status of the program or content of the cost history.

Our continuous reviews of the factor packages indicate that the contractor does not generally classify cost within his cost accounting system according to activities that are recurring or nonrecurring. Further, the displayed cost accounting data may contain costs that represent incurred cost for separately priced contract line items. No attempt is generally made by the contractor to screen nonrecurring type costs or costs specifically incurred under separate contract funding from the historical data base used to derive the direct cost factors.

Examples of types of activities whose cost should be classified as nonrecurring or otherwise classified as separately priced or funded in contracts are:

(1) Costs for deliverable technical manuals or data items.

(2) Costs associated with rate tooling or replacement tooling when specifically priced or funded in contracts.

(3) Costs applicable to an engineering change when such costs are specifically priced or funded or anticipated to be priced or funded in a contract or modification to a contract.

(4) Costs for warranty and/or significant repairs which are covered by specific contract terms or otherwise of a one-time nature. Under these conditions, historical direct cost factors may not be representative of future costs under a given initial pricing proposal.

Also, the contractor does not provide quantifiable direct cost projections based on future program requirements (program budgets). Accordingly, Government analysts do not generally have a basis to determine the reasonableness of the contractor's judgment applied to historical direct cost factors.

b. Recommendation.

The contractor has extensive capability to classify incurred direct costs according to recurring and nonrecurring activities as well as accounting for separately priced contract line items through the existing "Project Order" and "Job Order" cost accounting structure. We believe that a lack of well defined written cost accounting procedures relative to direct cost classifications significantly contribute to this condition. We recommend that the contractor develop and consistently follow written cost accounting procedures which define activities according to their nature so they may be appropriately classified in the accounting records. Such procedures should provide that the accounting records visibly reflect or provide ready identification of nonrecurring, recurring costs as well as those costs associated with items separately or distinctly priced in contracts. We believe that a significant amount of time could be saved on the part of the contractor and the Government and a reduction to negotiation disputes could be achieved if an advanced agreement could be reached relative to the proper classification of costs in the historical data base. Further, we recommend that the contractor prepare trend data and project program direct cost factors based on quantifiable program budgets for known and anticipated future business within each program. Such a direction on the part of the contractor, in our opinion, could lead in the future to negotiations of Forward Pricing Rate Agreements (FPRA) covering direct cost factors. Negotiated FPRA's would mutually reduce Contractor/Government time on preparation and review of initial pricing proposals, speed up the cycle time, and reduce negotiation disputes.

c. Contractor's Reaction.

The gist of the recommendation deals with changes to the accounting system. Our comments regarding the accounting system are addressed elsewhere in this report.

d. Rejoinder to Contractor's Response.

Although our comments do relate to the accounting system, we are not asking for "changes" in the accounting system. We are asking the contractor to be more consistent in charging costs to accounts or GWO's, and we think that by developing more complete written procedures along with applying some internal control, the accounting system would be more useful in the development of factors. Since these factors equate to about $150 million annually, we consider the problem significant. The contractor spends considerable time preparing factor packages for proposals and their procedures call for the elimination of nonrecurring costs as well as those costs separately priced in contracts. They generally do not follow their own procedures and the Government spends considerable time attempting to evaluate the factors. We believe that if we could reach an agreement, much time and misunderstanding could be saved by all parties. This is a major problem in nearly all proposals.

C. CONTRACTOR DATA AND DESCRIPTION OF ESTIMATING METHODS AND PROCEDURES.

1. Contractor's Organization and Products.

a. Corporate Structure. Texas Instruments, a Delaware Corporation, was organized in 1930 as Geophysical Service Incorporated to provide geophysical services for the petroleum industry. The name was changed to General Instruments Incorporated in January 1951 when the company became engaged in manufacturing, engineering and research activities. General Instruments name was changed in December 1951 to Texas Instruments Incorporated (TI). The corporate headquarters is in Dallas, Texas with numerous other facilities located in the United States and worldwide. These facilities are managed by operating groups which are responsible for producing a multitude of primarily electronic products. The operating groups are essentially independent organizations reporting to a Group Vice President and having their own management, engineering, production, and marketing responsibilities. In addition, each group provides coordinated technical direction and research for all divisions of that Group. In addition to the corporate offices, the principal operating Groups are Semiconductor, Materials and Electrical Products, Consumer Products, Services, Digital Systems, Electrical Controls, and the Equipment Group (Government Electronics). Combined sales (Net Sales Billed) for Calendar Years 1979 and 1980 were as follows:

	(Millions)
1979	$3,224.1
1980	$4,074.7

b. Equipment Group. The Equipment Group is the primary segment of Texas Instruments Incorporated doing business with the Government. This Group is comprised of Radar Systems Division, Electro-Optics Division, Communication/Navigation/Intelligence Division, Defense Suppression/HARM Division, Business Development, Advanced Technology Lab, and a number of support functions necessary for design, development, and manufacture of high-technology electronic systems and subsystems for use by military departments and civilian agencies of the U. S. Government and other customers. Major systems and subsystems include application of advanced technology and innovation in the following areas:

Defense Supression Weapons
Modular Weapons
Antiship Weapon Guidance
Antiarmor Weapons
Advanced Weapon Technology
Forward Looking Infrared
Infrared Night Sights
Fire Control Systems
Surface Radar
Navigation and Attack Radars
Communication and Navigation Equipment
Air Traffic Control Systems
Computer Systems
Surveillance and Ocean Control
Antisubmarine Warfare

Equipment Group sales (Net Sales Billed) including related Government sales for Calendar Years 1979 and 1980 were as follows:

Year	Total Sales ($000)	Gov't Sales ($000)
1979	573,190	449,127
1980	770,630	571,530

The Equipment Group currently operates manufacturing facilities in Dallas, Lewisville, Sherman, Plano, and Austin, Texas, and Colorado Springs, Colorado.

Government contracts are priced and negotiated by Contract Services which is managed by (Deleted) Contract Administration for Government Contracts and Cost Estimating Departments, operating under (Deleted) respectively, report to The Contract Administration Department has the responsibility for logging in all requests for bids and timely submissions of quotations to the Government.

2. Estimating Methods and Procedures.

The contractor formally issued a Cost Estimating Manual dated 1 August 1980. Major elements of the contractor's estimating process are explained below:

a. Initiating an Estimate. Upon receipt of a solicitation from a customer, the contract negotiator or administrator or a representative of the project prepares a Bid Estimate Request (BER). Approval must be obtained from a division requirements manager if the BER covers efforts which are not part of the business plans of the product division. An initial review meeting is required for a BER for which the proposed price may exceed $100,000. The purpose of this meeting is to identify the proposal team (proposal manager, engineers, manufacturing engineers, and support personnel), identify accumulation methods, and to establish the schedule. Also, the proposal manager identifies probable Bill of Material items requiring make or buy analysis. An Estimate Plan is prepared which reflects the information sources to be used and estimating techniques selected.

b. Making the Estimate.

(1) Direct Materials. The Bill of Material (B/M) may be either computer generated (IM5 System) or manually prepared. The IM5 System is discussed in Section B of this report (see paragraphs 5, 6 and 7). For programs involving initial design effort for items which have not been previously developed or manufactured, a manually generated B/M may be prepared by cognizant engineering personnel, and priced by material costing in the Purchasing Department or by a Cost Estimator. Portions of direct material costs may be estimated by use

of direct cost factors developed from historical data such as General Work Order, Tooling and Engineering Material (see Section B, paragraph 9).

(2) Direct Manufacturing Labor. Direct manufacturing labor may be estimated by analysis of the tasks to be performed, from historical data, or other method. Estimates based on history generally take the form of the "Rollup Run Cost" format, discussed in Section B, paragraph 1 to this report, although other historical analyses may be used as bases for estimates. On new projects, conceptualized approaches may be taken with estimates made on an overall basis or on a part by part basis depending upon imposed time restraints. Portions of direct manufacturing effort such as General Work Order, Sustaining Tooling, and Manufacturing Engineering may be estimated by use of direct cost factors (see Section B, paragraph 9).

(3) Tooling and Test Equipment. New estimates are generally made for tooling and test equipment requirements in circumstances where there are changes in production rates or for initial production contracts.

(4) Direct Engineering Labor. Estimates take the form of manloading or by use of a direct cost factor using program/project historical relationships of engineering costs to manufacturing labor costs exclusive of manufacturing engineering costs.

(5) Field Service. Field Service effort usually takes the form of manmonth/manday engineering estimates including allowances per TI Standard Procedures and Policies.

(6) Other Direct Costs. Such costs include travel, interdivisional transfers at cost, and internal computer services. Estimating techniques include:

Travel - By number of trips multiplied by an average experienced trip rate or by a percentage factor derived from history.

Interdivisional Transfers at Cost - By specific cost estimate or by a percentage factor derived from history.

Computer Services - By estimated CPU hours multiplied by a computer rate or by a percentage factor derived from history.

(7) Forward Pricing Rate Agreements (FPRA).

(a) Direct Labor Rates. The forecasted direct labor rates are submitted to DCASPRO who requests DCAA to perform a verification and evaluation. DCASPRO and TI then negotiate the rates prior to their use by cost estimators. Projected labor rates are based on the then current actual average Equipment Group "Plant-Wide" rates by labor category. Projections are made to midpoint of specified time periods (periods of performance) and consider such items as employee turnover, merit increases, and escalation. Overtime premium and shift pay differential are included in overhead. Actual experienced direct labor rates are reviewed monthly by DCAA. New labor rate forecasts are submitted periodically at the request of either the Government or the contractor. Direct Labor Rate FPRAs are generally negotiated twice a year.

(b) Overhead Rates. The contractor's indirect expense pools and applicable bases are as follows:

Base	Expense Pool
Engineering Direct Labor Dollars*	Engineering Overhead
Manufacturing Direct Labor Dollars*	Manufacturing Overhead
Field Service Direct Labor Dollars*	Field Service Overhead
International Field Service Labor Dollars*	TIICC (International Field Service)
Direct Material Costs	Material Overhead
Group Cost Input	General and Administrative Expense**

*Excludes overtime premium and shift pay differential.
**Includes bid and proposal expense, Group IR&D expense and an allocation of Corporate Office G & A and IR&D expenses.

The forecasted overhead rates are based on contractor budgets or a combination of cost incurred and budgets for the remaining portion of the year. Forecast data are submitted to DCASPRO. Such data are then evaluated by DCAA and DCASPRO giving due consideration to historical trends, statistical analyses, and Government regulations. DCASPRO and TI then negotiate the rates. Interim actual rates are reviewed monthly for comparison to negotiated rates and for trend indications. Forecasted rates are submitted by the contractor periodically at the request of the Government or at their discretion, but generally once or twice a year.

(c) Cost of Money Factors. Cost of Money (COM) factors are periodically negotiated under FPRAs. These factors consider average asset book values employed or allocated to the several overhead pools described above, and appropriate published Secretary of Treasury Interest Rates. COM is allocated to individual contract proposals by application of the negotiated factors to the proposed contract overhead bases.

(8) Major Computer Systems. In addition to the IM5 System, the contractor may employ the FP-5 and FP-6 System. The FP-5 System is work breakdown structure oriented and is used to accumulate estimates of the cost elements of the work breakdown structure in the format required by the price proposal. The FP-6 System is oriented to the engineering design structure and is used to accumulate material and shop labor estimates for the manufacturing part of a proposal.

c. Finalization of the Estimate. After estimates are accumulated and contractor internal reviews and approvals are made, the DD Form 633 is prepared. Information used in preparation of the estimate is assembled into a Cost Estimating File except that references are made to that data not physically contained in the file.

DEPARTMENT OF DEFENSE
OFFICE OF THE INSPECTOR GENERAL
WASHINGTON, D.C. 20301

Audit Policy
and Oversight

MAR 9 1984

MEMORANDUM FOR DEPUTY UNDER SECRETARY OF DEFENSE RESEARCH AND ENGINEERING (ACQUISITION MANAGEMENT)
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Report on Oversight Review of the Access to Records by Defense Contract Audit Agency

This is our report on the Defense Contract Audit Agency's (DCAA) access to contractor records. This is the second in a series of three reports on our oversight review of selected aspects of DCAA operations. The oversight review was performed from July 1983 to November 1983. The review objectives were to determine whether DCAA was obtaining full access to contractors' records needed for audit accomplishment and whether access problems, when encountered, were resolved in a timely and effective manner.

Our review showed that DCAA field auditors were actively pursuing and generally receiving access to those contractor records required for audit accomplishment. Access problems of varying degrees were encountered by DCAA auditors at most of the locations visited. Significant access problems of a long duration existed at three major DoD contractor locations.

The DCAA auditors were entitled, by law and contract terms, to the records denied by contractors. We concluded that more aggressive action and improved controls were required by DCAA in obtaining contractors' records required for audit functions. Actions recommended include (i) withholding of payments to contractors if requested records are not provided within 30 days; (ii) refusal by DCAA to issue audit reports when supporting data and records are not provided for contractors' proposals; (iii) strengthening of acquisition regulations to make the audit of all proposals in excess of $500,000 mandatory; (iv) increased support by DoD procurement officials in assisting DCAA auditors to resolve access problems with contractors; and (v) improved monitoring and oversight of access problems by DCAA Headquarters. The details on the results of our review are contained in Part II of this report.

A draft of this report was provided to the Director, Defense Contract Audit Agency and the Deputy Under Secretary of Defense for Research and Engineering (Acquisition Management) for review and comments. In Part II of the report we have included their comments on each of the recommendations and our responses thereto. The Director and Deputy Under Secretary nonconcurred with all of the recommendations primarily on the basis that existing policies and procedures were adequate. We still believe that the recommendations should be implemented. Based on our review of the comments we included additional recommendations involving actions by the Defense Contract Audit Agency.

Final positions of the Director, Defense Contract Audit Agency and Deputy Under Secretary of Defense should be provided to us within 60 days of the date of this report.

James H. Curry
James H. Curry
Assistant Inspector General
for Audit Policy and Oversight

REPORT ON OVERSIGHT REVIEW OF DEFENSE CONTRACT AUDIT AGENCY ACCESS TO CONTRACTOR RECORDS

REPORT NO. APO 84-5

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REPORT ON OVERSIGHT REVIEW OF THE DEFENSE CONTRACT AUDIT AGENCY'S ACCESS TO CONTRACTOR RECORDS

PART I - INTRODUCTION

The review was made as part of our responsibility for overseeing and evaluating the Defense Contract Audit Agency's (DCAA) compliance with prescribed audit standards, policies, and procedures. The DCAA's mission is to perform all necessary contract auditing for the Department of Defense (DoD), providing accounting and financial advisory services to DoD procurement and contract administration activities for the negotiation, administration, and settlement of contracts and subcontracts. The DCAA also provides contract audit services to non-DoD Government agencies. The role of DCAA in providing these services is that of an independent advisor to the contracting officer. The DCAA is a separate agency of the DoD under the direction, authority, and control of the Assistant Secretary of Defense (Comptroller).

Background

Full and unrestricted access to contractor's records is essential in order to examine sufficient competent evidential matter to afford a reasonable basis for an informed opinion in the variety of contract audit functions performed. Restrictions on access to contractor's records can impair the auditor's ability to render informed opinions and must be promptly resolved through appropriate actions with the contractor, contracting officers, and acquisition authorities.

The DCAA performs a variety of accounting, auditing and financial services for DoD and civil procurement activities. These services include estimating system reviews, audits to determine financial capability, accounting system reviews, contract proposal evaluations, defective pricing audits, Cost Accounting Standards cost impact and compliance audits, etc. Most of the Agency's work can be categorized into two basic types of audits, incurred costs and pricing proposals. Under incurred cost audits the DCAA auditor reviews contractors' cost representations and determines whether the actual costs incurred in performing contracts are reasonable, allocable to the contract, and not prohibited by contract terms, government statute, or regulation. Audits of incurred costs cover areas such as cost reimbursable contracts, equitable adjustments, terminations, operations audits for economy and efficiency, etc. In order to adequately perform incurred costs audits the auditor needs unrestricted access to all relevant contractor books, records, documents and other competent audit evidence. Audit evidence also includes information received in response to inquiries or interviews and evidence obtained by direct observation of activities or operations.

Each DoD contract awarded since November 1967, other than those entered into by formal advertising, contained an "Audit by Department of Defense" clause (Defense Acquisition Regulation (DAR) 7-104.41) requiring the contractor to maintain and grant to DoD the right to examine books, records, documents, and other evidence and accounting procedures and practices, including the right to inspect the contractor's plant engaged in the performance of the contract. Paragraph (c) of the clause grants the Government the right to examine all such records related to negotiation, pricing, or performance of the contract for the purpose of postaward evaluation of the accuracy, completeness and currency of cost or pricing data submitted in establishing the contract price. All records required to be provided under the clause are to be made available at all reasonable times at the contractor's office or facility.

Pricing proposal audits are evaluations of contractors' estimates of cost and profit submitted in connection with the negotiation of prices for fixed price contracts, adjusted prices for redeterminable contracts, spare parts orders, cost-type contracts, etc. In reviewing contractors' pricing proposals the auditor must consider items such as the adequacy of the cost accounting system, the contractors estimating methods, historical costs of like or similar items, and budgetary data to assist in evaluating the reasonableness of the indirect cost projections. In order to accomplish a pricing proposal review the auditor needs access to all relevant contractor books, records, and other data necessary to support the contractor's cost or pricing data. By submitting their proposal on DD Form 633, "Contract Pricing Proposal" contractors grant the Government the right to examine their books, records, documents, or other cost or pricing data which will permit adequate evaluation of their proposals for new contracts.

In a May 10, 1979 report (B134912), the General Accounting Office (GAO) reviewed DCAA's access to budgetary and other cost data supporting contractor's price proposals. They reported that DCAA was experiencing problems in access to budgetary data and was entering into agreements with contractors defining, and thus, limiting the amount and kind of budgetary data to be provided. We did not find any formal agreements entered into between DCAA and contractors.

Objectives and Scope of Review

Our review began in July 1983 and was completed in November 1983. The objectives of our review were to:

- Determine the extent of problems being encountered by DCAA auditors in obtaining access to contractor documentation required for full audit accomplishment.

- Evaluate the adequacy of DCAA policies, procedures and practices for effective and timely resolution of access problems.

This area was selected for oversight coverage based on our review of a preliminary investigation report prepared by the Office of the Special Counsel, Merit Systems Protection Board, on allegations by a DCAA employee. Based on the information contained in the investigative report, we selected three areas for oversight coverage to determine whether the operational problems alleged by the DCAA employee had broader or systemic implications. These areas included access to contractors' records, reporting of fraud or illegal acts, and accuracy of reported savings resulting from DCAA audits. Our oversight reviews did not include an evaluation of the validity of specific instances alleged by the DCAA employee to the Office of the Special Counsel.

The period covered by our review was FY 1980 through FY 1983. We surveyed DCAA Headquarters to determine and evaluate the policy and procedure currently in effect and the extent of control and monitoring of access to records problems experienced by field auditors. Our field tests of the implementation of Agency policy and procedure were accomplished by visiting four of the six DCAA regional offices and 28 field audit offices (FAOs) or suboffices. A list of the offices visited are shown in Appendix A. The DCAA has approximately 128 FAOs with 181 suboffices.

Our field review encompassed an examination of all denials of access to records problems experienced during the past four fiscal years at the FAOs visited. Six locations visited were selected because of suspected problems and the remaining locations visited were selected at random. We also conducted tests of correspondence files and files of audit reports to determine the existence of any unreported access to records issues. Discussions were conducted with senior audit personnel at all regional and FAO offices to determine the extent of problems, if any, experienced in obtaining necessary records under the DoD contract audit clause.

PART II-RESULTS OF REVIEW AND RECOMMENDATIONS

A. Audits of Contractors' Proposals

Improved controls were required to ensure that DCAA auditors obtained timely access to all contractor documents required for the effective evaluation of contractor proposals. Significant access problems have been encountered by DCAA auditors at three of the major contractors included in our review. Many of these access problems have existed for years. DoD procurement activities continued to award contracts to these contractors even though they were aware that DCAA was denied access to contractor documents to which the auditors were legally entitled. Moreover, the ability of DoD procurement officials to waive the requirement for audits of major contract proposals has weakened the internal control role of DCAA in the procurement process. As a result, DCAA auditors issued highly qualified reports of limited, if any, usefulness in the negotiation process; DCAA audit resources were not effectively utilized; and the Government's internal controls to assure the reasonableness of negotiated contract prices were compromised.

Discussion

The Defense Acquisition Regulations (DAR) 3-801.5(b) requires, with exceptions, an audit of contractor price proposals submitted for contracts of $500,000 or more awarded on the basis of cost or pricing data. Form DD 633 "Contract Pricing Proposal" is DoD's standard form used by contractors to submit proposals for new contracts. This form provides specific guidance as to the data and format requirements for contractor proposal submissions. It specifically requires contractors to sign a statement granting the Government the right to examine, for the purpose of verifying the cost or pricing data submitted, those books, records, documents, and other supporting data which will permit adequate evaluation of such cost or pricing data, along with computations and projections used therein. Additionally, Public Law 87-653, "Truth in Negotiations Act," requires that the cost or pricing data submitted must be current, accurate and complete. This requirement places the burden on contractors to disclose all pertinent data to the Government to assure the accuracy, completeness and currency of its proposal up to the date of reaching an agreement on price. The law has been interpreted by the appeals board to require contractors to specifically identify data in its books and records and not merely make the books and records available for information.

The DCAA's policy concerning audits of contractors proposals when records are denied are essentially covered in the Contract Audit Manual (CAM) 1-206.3. Paragraph (e) provides that the audit should not be interrupted if available records will provide sufficient information upon which to base a useable report, but the unsupported costs are to be questioned and the report appropriately qualified. Paragraph (f) advises that where denial is so extensive that it is impractical to continue the audit, the activity requesting the audit should be promptly notified that a report cannot be furnished. Paragraph (n) provides that the most effective means of obtaining access to needed records is to promptly refer the matter to the procurement contracting officer (PCO) for action as contemplated by DAR 3-807.5. The DAR section provides that the contracting officer should withhold making the award of the contract if the contractor persists in denying supporting data.

Our review disclosed that significant delays and denials of records supporting contractors' proposals occurred at three major contractor locations. This condition had persisted at two of the contractor locations for years and had become an acceptable means of operation to DCAA auditors. Additional details on the access problems at these three contractors are presented below.

o The delays or denials of access to supporting cost and pricing data at a major electronics contractor location have continued for years without resolution. They consist of denials to the general ledger, trial balance, accounting records for direct labor costs and scrap, journal entry support, work-in-process job costs, bills of materials, etc. Over 100 audit reports issued during the period of June 1982 to September 1983 were reviewed during our field review. Nearly every report contained a significant qualification.

Discussions with the local Defense Contract Administration Services Plant Representative Office (DCASPRO) expressed concern over the lack of any support from DoD procurement activities to resolve this condition. The contractor consistently denied access to data for proposals of less than $500,000, even though a request for audit was made by the local DCASPRO. Despite the severity of these conditions, we found no evidence that the disputed issues were elevated to DCAA Headquarters for assistance in resolving the matter. Contract Audit Manual 12-702 provides for reporting these unsatisfactory conditions to DCAA Headquarters.

o Likewise, a similar condition existed at a major electronics contractor location for at least six years and has yet to be elevated to DCAA Headquarters. The contractor has continually denied access to material cost performance records in support of price proposals. In a September 1983 memorandum to the DoD procurement command, the auditor stated:

> "In this case the contractor has refused to provide...the actual cost incurred on seven prior contracts and current inventory records for our review and evaluation. There can be no doubt that this is significant pricing data...covered under the law. This office cannot expect less than full disclosure without qualifying our audit report. If we would do so, we would be aiding the contractor in his efforts to avoid this requirement of the law."

Public Law 87-653 has required contractors to provide access t performance records since 1967. The DoD procurement activities continue to negotiate contracts with the severely qualified audit reports and have failed to take corrective action with the contractor. The local Defense Contract Administration Services Management Area office was frustrated by the lack of support from procurement activities to resolve the condition. DAR 3-807.5 requires procurement activities to withhold award of contracts until contractors provide sufficient cost or pricing data.

o Our review also disclosed similar conditions in varying degrees at a DCAA resident office of a major aircraft manufacturer. In one case involving a $3.8 billion multi-year procurement, the FAO's report was highly qualified due to denials of access and use of numerous outdated pricing factors by the contractor and limitations on the scope of audit by the requesting procurement activity. The procurement office only requested a limited review, a restriction on the scope of audit, but DCAA properly attempted to cover all areas of the proposal in the time allowed, pointing out the numerous deficiencies. Paragraph 2 "Special Circumstances Affecting the Examination" of the FAO's audit report consisted of five pages of qualifications with the conclusion that cost or pricing data submitted by the offeror were not adequate for negotiation of a contract. Despite this conclusion the procurement office negotiated the contract on a fixed-price incentive basis.

We believe additional controls are needed to ensure that DCAA obtains timely and full access to contractor records to which it is legally entitled for audits of contractor proposals. These controls involve restrictions on the issuance of qualified audit reports and the strengthening of DCAA's role in the evaluation of contractor proposals.

A relatively short period of time is normally allowed for DCAA to audit a contractor's proposal, e.g., 30 days. Therefore, it is essential that the Agency's auditors obtain access to contractor records and other supporting data in a timely manner. If such records or data are not provided during the period allotted for the audit, it is DCAA's practice to issue a report with qualifications on the scope of the audit coverage and question the costs for which supporting data was not provided. Contract Audit Manual 10-302.3 provides a series of standardized qualifying options that DCAA auditors may include in audit reports. Some of these deal with inadequate supporting data and access to records problems.

Examples of the qualifications that may be included in audit reports, depending on the circumstances encountered, include:

> "In our opinion, the cost or pricing data submitted by the offeror are not adequate."
>
> "The offeror has denied access to the following data needed to evaluate the proposal."
>
> "Therefore, we do not consider the proposal to be acceptable as a basis for negotiation...The proposal has, nevertheless, been evaluated to the extent possible in the circumstances."

The DCAA Headquarters did not maintain statistics on the number of qualified reports issued by its field offices due to inadequate supporting data or denial of records. It is generally acceptable, if not common practice, to issue such qualified reports as recognized by Agency policy. As discussed previously, extensive use was made of such qualifications in audit reports applicable to three major contractors included in our review.

DoD procurement officials readily accept qualified audit reports as fulfilling the DAR requirement to obtain an audit of the contractor's proposal and they proceed with the negotiation of a contract. This is true, no matter how significant the qualifications contained in the audit report are. Contractors are well aware of the time restrictions placed on DCAA audits. In many cases, the supporting data denied to DCAA auditors is subsequently provided to DoD procurement officials just prior to or at the time of contract negotiations. The supporting data subsequently provided by contractors to procurement officials is seldom given to DCAA for audit.

As evidenced by the conditions discussed above at the three contractor locations, the issuance of qualified reports tend to perpetuate rather than resolve access problems. We believe a more appropriate course of action is to refuse to perform an audit until needed records and supporting data are provided by the contractor when DCAA auditors experience delays restricting the scope of audit, denials of access to significant data, or data is inadequate to support the negotiation of a contract. While such action is provided for in the CAM, there was a reluctance by DCAA auditors to take such a course of action. We found few instances where DCAA auditors refused to perform audits because of nonavailability of adequate supporting data or denial to contractor records. We believe that the use of qualified reports reduces the usefulness of DCAA audits to DoD procurement officials and mitigates the internal control role of DCAA in the procurement process.

Another factor that circumvents the internal control role of DCAA is the ability of DoD procurement officials to negotiate major contracts without obtaining a DCAA audit. Prior to 1972, the Armed Services Procurement Regulations (ASPR) Section 3-809(b) stated that the contracting officer "...shall request an audit review by the contract audit activity...." In 1971, the Defense Contract Audit Advisory Council (Malloy Task Group) recommended that ASPR 3-809(b) be revised to deemphasize "...the mandatory nature of the requirement for audit review by substituting the words 'should normally request' for the words 'shall request'." Both the Director of DCAA and the Assistant Secretary of Defense (Comptroller), who served on the Task Group, objected to the changes stating that they "...doubt the wisdom, from the DoD point of view of issuing a report (Malloy Task Group Report) which urges contracting officers to waive audit evaluation of price proposals...."

Despite the objections, the council made the recommendations and the ASPR was subsequently revised, as now stated in DAR 3-801.5(b) (see Appendix B). With the current wording of DAR, the contracting officer can waive the audit requirement for any proposal, regardless of value, if other available information "...is considered adequate to determine the reasonableness of the proposed cost or price." Field audits have been waived or restricted for procurements as high as a billion dollars, despite evidence from prior DCAA reports that significant deficiencies existed in the contractor's estimating and accounting systems and/or proposed costs.

On November 3, 1983, the Deputy Secretary of Defense issued a memorandum to all DoD Components to reemphasize the need to comply with DoD policies and procedures for negotiated single source procurements (see Apendix C). The memorandum provided that any deficiencies in contractors' cost and pricing data should be immediately corrected. Also, the contracting officers should obtain field pricing reports, including both technical reviews and audits. Our review was completed in November 1983. Therefore, we were unable to ascertain what impact the subject memorandum may have had on eliminating the types of problems discussed in this section of the report.

Recommendations

We recommend that the Director, Defense Contract Audit Agency:

1. Take immediate action toward resolving the access problems by meeting with heads of major procurement activities cognizant of the two resident offices encountering the significant access to records problems. Should the issues not be resolved at the procurement activities level, they should be elevated to the Under Secretary of Defense Research and Engineering (OUSDR&E) for their assistance until a satisfactory solution is achieved.

DCAA Comments

The access to records problems have been resolved.

Recommended Action: Delete this recommendation.

OAIG-APO Response

Understandings reached between DCAA and officials of the two contractors on the release of previously denied records occurred after our visits to the DCAA field offices and the completion of our review. We will followup at a later date on the implementation of the access agreements between DCAA and the two contractors.

2. Provide field offices guidance not to issue an audit report on any part of a contractor's proposal when denials and/or delays in access to records are encountered or when supporting data is considered inadequate for negotiation of a contract price. These denials and/or inadequate data must be promptly reported to the contracting officer and copies of such reports provided to the Assistant Secretary of Defense (Comptroller), OUSDR&E (Acquisition Management), and to the Office of the Assistant Inspector General for Audit Followup.

DCAA Comments

We disagree with this recommendation. We believe it is essential for the contracting officer to be provided contract audit support when circumstances require proceeding with the acquisition regardless of access or other support problems. Of course, the audit report should clearly identify the deficiencies and an adverse opinion should be made regarding the proposal as a whole when appropriate. The contracting officer's action becomes a matter for review by his or her management and by the IG.

Recommended Action: Delete this recommendation.

OAIG-APO Response

We believe that DCAA plays an important internal control role in the procurement process through its independent audit of contractors' proposals for contract costs. For this reason, DCAA was established as an independent organization, separate from the procurement function. This internal control role is compromised or voided when DCAA is denied access to contractor's records or is not provided with adequate supporting data for proposed contractor costs. The issuance of highly qualified or adverse opinion reports indicate that DCAA was unable to fulfill its internal control role.

It would be in the best interests of the Government that such problems be resolved before DCAA completed its audit work. Such actions would be in line with recent guidance issued by the Deputy Secretary of Defense. In a memorandum dated November 3, 1983, subject "Negotiated Single Source Procurements," the Deputy Secretary of Defense stated, in part, that:

> "One of the most significant steps in the evaluation of the proposal is to determine if it provides an adequate basis for negotiations. Of particular concern in this respect is whether or not adequate cost or pricing data, has been provided. Deficiencies noted in this process should be immediately corrected."

Highly qualified or adverse opinion reports are of little use to the contracting officer and seldom lead to the correction of the deficiencies that resulted in the qualified reports. Our review showed that contracts were negotiated even when DCAA issued such reports.

Until such time as the DAR recognizes that highly qualified or adverse opinion reports will preclude further negotiations of contracts, DCAA has no other alternative than to advise the contracting officer that it cannot issue an audit report unless the underlying access or supporting data problems are corrected. The refusal of DCAA to issue a report in such situations should preclude further negotiations on contracts.

3. Require regional offices to provide DCAA Headquarters with recurring reports on the number and types of qualified audit reports issued by their field offices.

OAIG-APO Comments

This recommendation was not included in a draft of this report. Reports that are qualified due to denials of or delays in obtaining records or the lack of adequate supporting data indicate the inability of the auditors to perform complete audits. This directly impacts DCAA's ability to fulfill its mission. Without some form of reporting procedure there is no way that DCAA Headquarters is made aware of the significant problems in the field.

We recommend that the Under Secretary of Defense for Research and Engineering revise DAR 3-801.5 to make mandatory the audit of all proposals for contracts in excess of $500,000 to be awarded on the basis of negotiation unless the waiver is

justified in writing and approved in writing by the head of the applicable procurement activity. The revision must require that audits be free of any significant qualifications due to contractor's denials or delays in providing supporting documentation or records. Also, the revised coverage must assure that any data submitted subsequent to completion of the field audit be provided to the auditor for evaluation prior to acceptance by the contracting officer.

Under Secretary of Defense for Research and Engineering Comments

Nonconcur. First, many contracts are negotiated on the basis of adequate price competition. In most cases, it would be a complete waste of audit resources to audit these proposals. Secondly, information of the type described in DAR 3-801.5(b) should be considered in determining the extent of any field pricing support that is needed. Therefore, an arbitrary rule to require audits of all negotiated contracts expected to exceed $500,000 would divert scarce professional talent to areas not needed at the detriment of other procurements. With respect to the issue of audits being free of any qualifications due to contractor's denials or delays in providing supporting documentations or records, DAR 3-801.5 provides guidance to the auditor on this matter and DAR 3-807.5 contains the necessary guidance to the contracting officer on the appropriate action that should be taken.

OAIG-APO Comments

Our review was directed toward contractors' proposals in excess of $500,000, when the price is based on cost or pricing data submitted by the contractor; not those contracts entered into on the basis of adequate price competition.

Adequate audits of contractor proposals are an essential and integral internal control feature of a sound procurement system. This internal control maybe compromised or negated when audits are waived or the auditor is unable to provide a proper audit because of inadequate cost and pricing data or denial of access to contractors' records. Highly qualified audit reports are evidence of the inability of the auditor to perform an adequate audit and are a "defacto" waiver of the audit requirement. Therefore, the acceptance of such qualified reports by the contracting officer does not in our opinion, constitute full compliance with the DAR provisions on audits.

The maintenance of this essential internal control feature requires actions by both the auditor and the contracting officer. The auditor needs to immediately advise the contracting officer of the factors precluding the performance of an adequate audit, while the contracting officer needs to take timely actions to resolve the deficient conditions.

We question whether a procurement system that permits the waiver of audits or the issuance of highly qualified reports on contracts involving hundreds ers of millions or billions of dollars is in full compliance with the spirit or intent of the Federal Managers' Financial Integrity Act of 1982. We recognize that circumstances do exist when it may be appropriate and proper to provide for a waiver of audits. However, we believe that circumstances noted during this review and other reviews clearly indicate the need for improved controls to preclude possible abuses. In the final report we have revised our recommendation to recognize the need for waivers while providing for reasonable controls over real and "defacto" waivers of audits.

B. Incurred Cost

The DCAA auditors were denied timely and full access by contractors to records needed for the effective accomplishment of incurred cost audits. While many of the access problems had been resolved at the time of our review, the procedures required to be followed by DCAA field auditors to resolve access disputes were cumbersome, time consuming and were not effectively monitored by DCAA Headquarters. Moreover, the ability of DCAA auditors to resolve disputes in a satisfactory and timely manner was hindered by the lack of any incentive for contractors to provide required records. These conditions result in a waste of audit resources and ineffective or untimely audit performance.

Discussion

The basis for DoD's access to contractor records is the contract audit clause contained in the DAR 7-104.41(a). This clause is inserted in all contracts of $100,000 or more, other than those entered into by formal advertising. It provides that under cost reimbursable contracts, the contracting officer or representative shall have the right to examine books, records, documents, and other evidence and accounting procedures and practices, sufficient to reflect properly all direct and indirect costs of whatever nature claimed to have been incurred and anticipated to be incurred for the performance of the contract. The courts and appeals boards have twice interpreted the clause concerning the Government's rights to access. Generally, the rulings have held that the need for data is left to the auditor's judgment.

The DCAA Policy on Access Disputes. The DCAA's policy emphasizes that every effort should be made to resolve access disputes at the "local level". CAM paragraph 1-206.3 (see Appendix D) provides for specific procedures to be followed in the resolution of access issues. In brief, this guidance provides that if discussions with contractor personnel are unsuccessful in obtaining the needed records, the DCAA FAO should submit a formal written request to the contractor for the denied records. If the FAO does not receive a reply from the contractor by a specified date, they must followup with the contractor before proceeding further. Should the contractor still refuse access, the issue must be formally explained and documented to the administrative contracting officer (ACO) along with several meetings with the ACO's staff.

Additionally, if a contract audit coordinator (CAC) exists, it and the corporate ACO (CACO) must also be briefed on the issue. This, in turn, requires further meetings between the ACO, CACO, CAC, and the contractor, as well as coordination with the regional audit offices. The FAO may then escalate the problem to its regional director. The regional director must then go through a similar scenario as did the FAO, that is, contact the contractor, ACO, CAC, etc. After all this, the auditor may be provided guidance by the regional director on suspending the contractor's costs.

Access Problems Identified During Review. From our review of access issues at FAOs we found that DCAA was not always receiving timely access to those contractor records which it was legally entitled and which was required for the timely and effective accomplishment of the audit mission. We believe that the primary reason for this condition is the lack of any real incentives for the contractor to provide needed records in a timely manner. Moreover, current DCAA policies unduly burden the DCAA auditors with cumbersome and time consuming procedures that result in penalizing the DCAA auditor instead of the contractor for the denial.

Five of 28 FAOs visited were branch offices that audited small contractors on a mobile basis. Access problems seldom occurred with small contractors. Of the remaining 23 FAOs, 17 were resident offices and six were suboffices cognizant of a single contractor. Six of the 23 were selected because of suspected access problems. We found that 13 of these 23 single contractor offices had experienced access problems of some form or another during the October 1979 to October 1983 period covered by our review and three were experiencing access problems at the time of our visit.

The extensive time and effort required to resolve the access problems could have been avoided if DCAA auditors had applied the most effective means for resolving access problems, that is, suspension of costs. When the requested records were obtained it was usually only after persistent efforts by DCAA field auditors over an extended period of time and extensive discussions with contractor, DoD procurement, and DCAA regional personnel. Typically, when the records were denied, contractors employed delay tactics, such as, discussing the need for the records, the proprietary nature of the information, the need to clear release with another department or manager, and so forth. This required considerable meetings and wasted effort on the part of the audit staff, and time spent by contractor personnel, the expense of which is substantially borne by the Government. The real issue is not that the access problem was resolved but the extended delays in resolving such access problems.

Examples of the conditions noted during our review follow:

o A major aircraft contractor refused an FAO, who had not been obtaining access to its year-end trial balance, when the record was requested for the first time in June 1983. Throughout the next three and a half months the contractor denied access while running the auditor-in-charge of the review back and forth between departments and numerous meetings trying to resolve the matter. It was not until September 16, 1983, that the auditor was given a copy of the trial balance, but with various account balances deleted, which negated the primary purpose for which the trial balance was sought. The FAO was not satisfied with this data and efforts are continuing to obtain the complete document. As of October 28, 1983 the FAO still had not received the full trial balance, approximately five months from the FAO's first request.

We believe the auditors were properly performing their duties in requesting the trial balance. The trial balance is an essential internal control in any sound accounting system. Without verification of this most basic control, the auditors have no assurance that the costs incurred by the contractor and claimed for payment on Government contracts are acceptable. Claimed costs may be traced back to a contractor's general ledger but unless the general ledger accounts are known to balance there is no assurance that claimed costs reflect all credits and adjustments due. Restricting access to just the general ledger is not an acceptable alternative to access to the trial balance. Large major contractors have highly sophisticated accounting systems which require elaborate reporting systems to produce the trial balance. It would be a long, laborious and unnecessary task for a DCAA auditor to manually prepare such a trial balance.

o At a major electronics firm DCAA requested access to the contractor's project control sheets in July 1979. The data was needed to evaluate the contractors compliance with Cost Accounting Standard (CAS) 403 "Allocation of Home Office Expenses to Segments," as applicable to the contractors allocation of corporate office management information systems cost to its segments. It took ten months before access was obtained to the project control sheets.

- In another instance at the same contractor, the FAO was denied access to contractor employees for the purpose of verifying the accuracy of labor charges to government contracts. It took from March 1981 until January 1982, ten months, to successfully resolve the issue.

- Another electronics firm, with over $830 million of annual sales to the Government, of which $207 million is for cost reimbursable contracts, continually denied or restricted access to basic accounting records. The auditors were denied access to asset, liability, and income accounts in the general ledger and trial balance. Data from the work-in-process job cost ledger was given to the auditor verbally and no examination was permitted for verification. Access to executive payrolls was totally denied and examination of the general payroll for verification of pay rates was severely limited. Various restrictions were placed on the interviews of employees (floorchecks) for the verification of labor charges to contracts. The contractor required one to two days notice before such floorchecks could be performed. This same contractor consistently denied or delayed providing cost and pricing data in support of its price proposals (see Finding B). The access to records problems were chronic at this contractor and the condition has gone unresolved for over four years.

- A major electronics firm, with an auditable volume of over $202 million dollars annually, first refused an operations audit of their Corporate Information Processing Center in early 1977. This review was finally completed in 1978 by working around the various contractor restrictions. A subsequent review, begun in 1978, was completely stopped due to the contractors denial of access to personnel and records supporting its word processing operations. In this instance, the field office issued a DCAA Form 1 "Notice of Contract Costs Suspended and/or Disapproved" suspending over $300,000 of costs for denial of access. The contractor appealed the suspension. The case was ultimately dismissed after the judge set a date for the parties to negotiate, leaving the entire burden on DCAA to reach a compromised agreement that would permit DCAA sufficient access to complete its audit.

- Another major contractor with over $830 million of annual sales to the Government, of which $207 million are for auditable contracts, dictates that only one operations audit may be in process at a time. In 1977, the contractor provided the regional office with a list of twelve rules for performing operations audits which DCAA still follows, as applicable, in order to perform operations audits. They include such things as: what cost centers DCAA will be permitted to review; that the next audit will not be commenced until a report is furnished to the contractor on the completed current audit; five working days advance notice must be given so appropriate personnel may be assigned to the review; interviews of contractor personnel may be conducted only in the presence of and after arrangements with management; all overhead reports must be issued no later than nine months after receipt of the contractors proposal, etc. As in the case of denials for other audits, these rules along with other restrictions cause numerous delays and effectively limit the FAO to performing but one operations audit per year.

o At a major shipbuilding contractor, incurring over $1.013 billion a year on government reimbursable contracts, the contractor would not provide the auditor with the details supporting their Energy Conservation Program or any other related internal activities. The contractor would only provide documents they believed the Government had a right to examine under existing contract clauses. The objective of the audit was to determine the reasonableness of incurred energy costs being charged to government contracts. New construction, fixed-price, contracts contained a special clause providing for reimbursement of energy related expenses based on actual costs incurred. The contractor was annually incurring energy related costs of $20 million or more. Again, as discussed above, this contractor's position only led to working around the problems or conditions in order to perform the reviews which compromised the effectiveness of the audits. The data was ultimately obtained and an audit report was issued on June 30, 1983, six months after the initial request for the contractor data.

Few, if any, of these issues were ever elevated to DCAA Headquarters for assistance in resolving the matter. There was only one instance of referral noted, even though DCAA's policy requires regions to promptly inform Headquarters when the FAO issues a formal written request for denied data. During our survey of DCAA Headquarters, they stated there were no such referrals to them, nor did we find any evidence of Headquarters awareness of the field conditions.

Unallowable and/or Unclaimed Costs. One of the highest instances of denial occurred in the access to details of unallowable and/or unclaimed costs. In most cases, sufficient information was obtained to facilitate a determination of the unallowable directly-associated costs, however, very few offices obtained the names of persons entertained, lists of passengers riding on contractor-owned aircraft, etc. Nor were most offices even asking for such details. Internal Revenue Service tax laws require such documentation for tax purposes. The reason given for not requesting the names was that the costs were not claimed and the contracting officer would not support them in obtaining the information. There was no evidence of elevating the issue to the contracting officer in these cases.

The DCAA's policy, as provided in CAM 1-201, states that although the primary purpose of contract audit is not the detection of fraud or similar unlawful activity, auditors must be constantly alert for such impropriety and to pursue resolution of their suspicions in accordance with CAM 12-701.3(a). We found no instances where the names of persons receiving gratuities were requested or where referrals for investigation were made when denied. Although the contractor does not claim the cost, the impact of Government personnel accepting gratuities has far-reaching implications for DoD procurements. Acceptance of gratuities by Government personnel is subject to the DoD code of conduct provisions and should be investigated.

Availability of Inspector General, Department of Defense, Subpoena Authority. Section 6(a)(4) of the Inspector General Act of 1978, as amended, states that the Inspector General may issue a subpoena for the production of all information, documents, reports, answers, records, accounts, papers and other data, and documentary evidence necessary in the performance of functions assigned to the Inspector General by the Act. On September 19, 1983, the Inspector General, DoD issued a policy memorandum on the "Issuance of Inspector General Subpoenas in Audits and Investigations." Under this policy memorandum, DoD audit agencies, including DCAA, may request issuance of an Inspector General subpoena in support of audits when it is in furtherance of a statutory function of the Inspector General. The Inspector General, DoD has encouraged use of this valuable tool in all situations where access to records is not otherwise available.

On October 27, 1983, DCAA forwarded the Inspector General policy memorandum to its regional directors advising them of its availability regarding access to records problems. The covering memorandum to the field advised the regional director that if a situation requiring the use of subpoenas is encountered they should submit a request to DCAA, Headquarters for processing.

Recommendations

We recommend that the Director, Defense Contract Audit Agency:

1. Revise Agency policy to provide contractors 30 days notice from the date of first denial that costs will be suspended if records are not provided. This revision will shift the penalty from the Government to the contractor and provide an incentive for contractors to cooperate in resolving the denial issues. If uniformly applied contractors will quickly learn that the burden of denials are to be borne by them and that no impartiality will exist in its systematic application.

DCAA Comments

We do not agree with this recommendation. We oppose an arbitrary 30-day delay period for suspending costs. If the access problem is related to costs being billed to the Government, it warrants immediate attention. On the other hand, if no current billings are affected by the access problem, imposing such a deadline may not allow adequate time to pursue informal resolution of the problem. It also tends to eliminate all judgment of the involved parties as to materiality of the impact, nature of the specific record requested, alternative sources of information, the types of audit and priority for completion, etc.

Current DCAA policies do call for suspension of costs for denial of access to records (CAM 1-206.3). In view of the IG's concern, we are issuing a memorandum to our audit offices emphasizing the need for quick action on access problems.

Recommended Action: Delete this recommendation.

OAIG-APO Response

The DCAA field auditors should not be placed in the position of negotiating for contractor records to which they are legally entitled for the timely and effective accomplishment of audits. As highlighted by the examples in this report, limiting DCAA actions to a dialogue with contractors does not always result in the timely access to denied records.

The strongest action available to DCAA auditors to force a resolution of access problems is the suspension of costs. This provides an incentive for the contractor to provide denied records. Under existing procedures and practices there appears to be a reluctance on the part of DCAA auditors and management to suspend costs in connection with access disputes. During our visits to DCAA field offices we found only one instance where costs were suspended because of an access to records issue.

On February 23, 1984, DCAA Headquarters issued the memorandum cited in their response to this recommendation (See Appendix E). This memorandum stated, in part, that:

> "As stated in CAM 1-206.3, auditors should promptly question and/or suspend cost amounts that are determined to be unsupported for lack of access to contractor records. There is no requirement that the the contractor be given formal advance notice that costs are to be questioned or suspended, and no "waiting period" is appropriate after the auditor has determined the amounts of unsupported costs related to a denial."

We do not agree that the existing provisions of CAM 1-206.3 provide for the prompt suspension of costs. Only after the DCAA field office and regional office have exhausted all means to obtain such records will the regional director provide the field office with "guidance regarding the suspending or questioning of unsupported costs." If the guidance in the February 23, 1984 memorandum was inserted in the CAM to replace existing guidance we would consider that such an action was responsive to the intent of our recommendation.

2. Require that all field offices and suboffices be surveyed to determine whether each FAO is requesting and obtaining access to all documents needed for their audits. The survey must emphasize complete access to all relevant data and should require the field office to verify any access of documents not requested during recent audits. It must not be assumed that access is granted if a record has not been obtained in the recent past and evidenced in audit files. The results of the survey should be tested at each FAO during the course of field visits by Headquarters personnel and covered by the Agency's peer review program.

DCAA Comments

We do not agree with this recommendation. It would be wasteful to expend resources in performing a survey which would serve no useful purpose.

Recommended Action: Delete this recommendation.

OAIG-APO Response

Access problems can have an adverse impact upon the effective and efficient performance of audits. Information obtained during this review and ongoing oversight reviews indicate that access problems exist at contractor locations other than those covered in this report. So we do not believe that the recommended survey would be a wasteful exercise. Inputs from the approximately 300 field offices and suboffices on the extent and degree of access problems would be of assistance to DCAA Headquarters in monitoring the effectiveness of actions to resolve access problems and evaluating the need for revisions to existing agency problems on this matter. This needed visibility or oversight is completely lacking at this time.

3. Issue guidance to field auditors to assure denials of unclaimed and/or unallowable costs are obtained to permit verification that directly associated costs are properly calculated and that the names of persons and organizations receiving the benefit of entertainment or other gratuities are requested. The list of names, when obtained, must be referred for investigation if any government employees, including military personnel, are noted. If the list of names is refused, the condition should be referred to investigative agencies for their consideration of the need for a formal investigation.

DCAA Comments

We do not agree with the portion of the recommendation requiring that the DCAA auditor obtain the list of DoD employees names suspected to be in violation of DoD Code of Conduct provisions.

The draft report states that "in most cases sufficient information was obtained to facilitate a determination of the unallowable directly-associated costs." The right to access to records of unclaimed costs is the subject of some disgareement, both between the Government and contractors and between some personnel in the Government. DCAA maintains that access is needed to perform audit of compliance with Cost Accounting Standard 405. We are in the process of preparing additional audit guidance for this purpose.

As to requesting the names of Government employees entertained, we believe that is for purpose of investigating compliance with Government code of conduct regulations. That is a function of the IG.

Recommended Action: Delete this recommendation.

OAIG-APO Comments

Auditing standards issued by the Comptroller General provide that:

> "Auditors shall be alert to situations or transactions that could be indicative of fraud, abuse, and illegal expenditures and acts and if such evidence exists, extend audit steps and procedures to identify the effect on the entity's financial statement."

The acceptance of gratuities by Government personnel from contractors may be an indication of fraudulent acts or abuse of the Governnent's code of conduct regulations. Under either case the provisions of the Comptroller General's auditing standards apply. These standards apply to all DoD auditors, including DCAA auditors. The acceptance of gratuities could simply be the "tip of the iceberg." Any practice that could compromise the performance of official duties by Government personnel should be properly investigated.

4. Revise guidance on the Agency's Mandatory Annual Audit Requirements (MAARS) to require field offices to obtain contractors' final annual trial balance, verify that it is mathematically correct, and that it accurately represents general ledger account balances.

OAIG-APO Comments

Subsequent to issuing our draft report DCAA, Headquarters advised all field offices that it was not mandatory to obtain contractors' annual trial balance. While we agree with the need to revise the existing MAARS, since it did not state the appropriate reason or need for the trial balance, we do not agree with the absence of a mandatory requirement to obtain the trial balance as verification of the control feature it provides, as explained in paragraph three, page 17, of our report. Accordingly, we have added the above recommendation which was not included in a draft of this report.

REGIONAL AND FIELD OFFICES VISITED

Atlanta Region

Bell Helicopter Textron Resident Office, Fort Worth, TX
General Dynamics--Fort Worth Resident Office, Fort Worth, TX
Harris Corporation Resident Office, Palm Bay, FL
Lockheed-Georgia Company, Resident Office, Marietta, GA
Texas Instrument Inc., Resident Office, Richardson, TX

Boston Region

AVCO Corporate-Lycoming Division Resident Office, Stratford, CT
Boston Branch Office, Boston, MA
Bridgeport Branch Office, Bridgeport, CT
Farmingdale Branch Office, Farmingdale, NY
GE-Lynn Resident Office, Lynn, MA
General Dynamics Electric Boat Resident Office, Groton, CT
Grumman Aerospace Corporate Resident Office, Lexington, MA
Raytheon Company Equipment Division Resident Office, Lexington, MA
UTC Sikorsky Aircraft Division, Resident Office, Stratford CT
Waltham Branch Office, Waltham, MA

Chicago Region

Chicago Suboffices Branch Office, Chicago, IL
  Northrop-Defense Systems Division Suboffice,
  Sundstrand Corporation Suboffice
G.D. Land Systems Inc., Resident Office, Troy, MI
McDonnell Aircraft, Resident Office, St. Louis, MO
McDonnell Douglas Corporate, Resident Office, St. Louis, MO
Pittsburgh Suboffices Branch Office, Pittsburgh, PA
  Rockwell Home Office Suboffice,
  Westinghouse Headquarters Suboffice,
St. Louis Branch Offices, St. Louis, MO
  Emerson Electric Suboffice
  G.D. Corporate Suboffice

Los Angeles Region

Hughes/El Segundo, Resident Office, Los Angeles, CA
McDonnell Douglas, Resident Office, Huntington Beach, CA
Northrop Corporate, Resident Office, Hawthorne, CA
San Diego Branch Office, San Diego, CA

APPENDIX C
DAR 3-801.5(b)
AUDITS OF CONTRACTORS PRICING PROPOSALS

(b) *Field Pricing Reports on Contract Price Proposals.*

(1) Prior to negotiation of a contract or modification resulting from a proposal in excess of $500,000, when the price is based on cost or pricing data (3-807.3) submitted by the contractor, the contracting officer (PCO or ACO) or authorized representative shall request a field pricing report (which usually includes an audit review by the contract audit activity), unless information available to the contracting officer is considered adequate to determine the reasonableness of the proposed cost or price. Whenever available data is considered adequate for a reasonableness determination, the contracting officer shall document the contract file to reflect the basis of the determination. Information of the type described in (i) through (vi) below, which is often available to the contracting officer from the Plant Rep/ACO or from the Procurement Liaison Auditor (PLA), should be useful in determining the extent of any field pricing support that is needed.

(i) In-house engineering determination of level of effort required in connection with research and development or study contracts.

(ii) Audited cost information from contract awards in process, or recently negotiated contracts.

(iii) Adequately reviewed data on proposed subcontracts items which constitute the major portion of the prime contract price proposal.

(iv) Prices of standard commercial items which constitute the major portion of the prime contract price proposal.

(v) Special forward pricing formulas or rates such as for support items, or forecast overhead rates, prescribed in an existing advance agreement.

(vi) Current labor rates, overhead rates, loading factors, per diem rates, and lot data based upon actual costs and labor hours.

It should be borne in mind that no single category of information is necessarily sufficient by itself, for example, information as to rates for labor and overhead would normally require data concerning the base elements—labor hours, material costs, etc.—to which the rates apply.

THE DEPUTY SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

8 NOV 1983

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
CHAIRMAN OF THE JOINT CHIEFS OF STAFF
UNDER SECRETARIES OF DEFENSE
ASSISTANT SECRETARIES OF DEFENSE
GENERAL COUNSEL
INSPECTOR GENERAL
ASSISTANTS TO THE SECRETARY OF DEFENSE
DIRECTORS OF THE DEFENSE AGENCIES

SUBJECT: Negotiated Single Source Procurements

The goal of DoD is to place as many contracts as possible on a competitive basis; however, a large dollar amount of contracts are awarded on other than a competitive basis each year. When contract prices are not established on the basis of price competition, extreme care is required to ensure that fair and reasonable prices are negotiated. Recent reports issued by the GAO, Inspector General, and Congressional Committees indicate a need to reemphasize some of our basic policies and procedures regarding negotiated single source procurements.

Acquisition Planning

Acquisition planning involves analysis of the technical and operational requirements and the documentation of the appropriate business strategy, and other acquisition policy considerations. To be effective, the plan must contain realistic milestones to be met in achieving the goals of a program. Accordingly, it is mandatory that adequate time be provided to allow for a proper evaluation of the contractor's proposal and for contract negotiations.

Preproposal Effort

A key element in the timely negotiation of a fair and reasonable price is to start with a well-prepared and well-documented contractor proposal. In this regard, we must ensure that contractor estimating systems are formalized and follow good estimating procedures; that contractor accounting systems properly accumulate costs for historical purposes; and that contractor purchasing systems are adequate. In addition, other contractor policies and procedures that affect the quality of cost proposals should be reviewed.

Evaluation of Contractor Proposal

One of the more significant steps in the evaluation of the proposal is to determine if it provides an adequate basis for negotiations. Of particular concern in this respect is whether or not adequate cost or pricing data, including prospective subcontractor cost or pricing data, has been provided. Deficiencies noted in this process should be immediately corrected. Field pricing reports should be obtained in accordance with the DAR. This includes a technical review as well as a financial review. While all of the cost elements in a proposal are important, purchased parts and subcontracts have been recently highlighted as having needed a more indepth review. Value analysis as well as cost and price analysis should be used on purchased parts. The prime contractor is responsible for performing an analysis of prospective subcontractor proposals. However, this must be reviewed for adequacy. The contractor's make-or-buy program should be reviewed and incorporated into the contract under the circumstances described in the DAR.

Negotiation of Contract Price

A prenegotiation price objective should be established for all negotiated procurements prior to the start of contract negotiations. Management approval of the objective should be obtained following departmental procedures. A record of price negotiations should be prepared at the conclusion of negotiations and, when required, a copy furnished to the ACO and auditor. It is important that this document address all significant issues discussed during negotiations.

I want to emphasize that this memorandum is not intended to represent a step-by-step guide in the contract negotiations process. It simply calls to your attention some of the more serious problems that have surfaced in the past few months. It is our joint responsibility to see that all personnel in the procurement branches of the Department are aware of these problems so they may be avoided in future contracts. I am also aware of your already increased workload in the procurement area. However, we must devote sufficient attention and resources to these procurements to ensure that fair and reasonable prices are negotiated. Your cooperation is appreciated.

Paul Thayer

Paul Thayer

Access to Records Policy
DCAA Contract Audit Manual

3-304.3 Access to Contractors' Records

(a) Thorough and comprehensive audits are possible only when there is made available to the auditor all existing evidence which pertains to the representations, claims or proposals of the enterprise under audit. In DOD contract auditing, the failure to make all pertinent records available to the auditor when they are needed leads to qualified audit reports and may result indirectly in more difficult negotiations and delay in the award of contracts for vitally needed materials and services.

(b) Access to contractors' records for purpose of audit may be provided by statute, implementing regulations, or contract terms. Usually, after the auditor has fully explained to the contractor the urgency and importance of submitting a timely and completely informative report to the contracting officer, it is not necessary to resort to statutory, regulative, or contractual sources in order to obtain access to needed records. However for the infrequent cases where statutory support is needed, it is contained in the provisions of 10 USC 2313(a) ("Examination of Books and Records of Contractor") and 10 USC 2306(f)(3) ("Truth in Negotiations Act — P.L. 87-653"). These statutory provisions have been implemented by the Department of Defense as follows.

(1) Contract Pricing Proposal Forms (DD Forms 633 series), which are designed for submission of cost or pricing data by prospective contractors require the contractor to include in its proposal a specific statement to the effect that "the offeror grants to the contracting officer, or authorized representatives, the right to examine, for the purpose of verifying the cost or pricing data submitted, those books, records, documents and other supporting data which will permit adequate evaluation of such cost or pricing data, along with computations and projections used therein."

(2) DAR 7-104.41(a) — This reference requires an "Audit" clause in all contracts other than those entered into by formal advertising which are not expected to exceed $100,000. This clause provides that under cost reimbursement type, incentive, time and materials, labor hour, or price redeterminable contracts, "the contractor shall maintain, and the contracting officer or representatives shall have a right to examine books, records, documents, and other evidence and accounting procedures and practices, sufficient to reflect properly all direct and indirect costs of whatever nature claimed to have been incurred and anticipated to be incurred for the performance of the contract." Further, if cost or pricing data are submitted in connection with the pricing of the contract, change or modification, the contracting officer or representatives "shall have the right to examine all books, records, documents and other data of the contractor related to the negotiation, pricing or performance of such contract, change or modification for the purpose of evaluating the accuracy, completeness and currency of the cost or pricing data submitted," unless the pricing was based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation. Provisions are also made for the insertion of similar clauses in all subcontracts. It will be noted, however, that firm fixed-price and fixed-price with escalation negotiated contracts with audit clauses dated prior to November 1967, did not provide access to contract performance records. This clause also provides for access to records if the contractor is required to furnish Cost Information Reports or Contract Fund Status Reports.

(c) It is incumbent upon DCAA auditors to use good judgment and reason in deciding what contractor records or other evidential material should be sought. The types of records needed by the auditor should be determined based on consideration of (1) the amount of Government business in relation to the total business of the contractor, and (2) the effect on the audit assignment. See 3-303.4 for additional guidance on access to contractor budgets, and 9-105.2 regarding cash flow forecasts.

(d) For purposes of defining records, the Supreme Court of the United States has held that the "records of a corporation import the transcript of its charter, and bylaws, the minutes of its meetings, the books containing the accounts of its official doings and the written evidence of its contracts and business transactions." (United States vs. Louisville and Nashville Railroad Co., Ky., 236 U.S. 318.)

(e) Should the auditor find it necessary to initiate the action set forth in paragraphs (g) through (l) below, the audit should not be interrupted if the available records will provide sufficient information upon which to base a usable report. However, when it is determined that a usable report can be issued, notwithstanding the contractor's denial, costs which cannot be supported due to unavailability of records should be questioned. In addition the "scope" paragraph of the report should be appropriately qualified. Costs under cost-reimbursement type contracts which are unsupported due to lack of access to records will be suspended in accordance with 8-303(a).

(f) In cases where the contractor's denial is so extensive that it is impractical to continue the audit, the activity requesting the audit should be promptly informed that the report cannot be furnished and the reasons therefor.

(g) When the contractor denies access to records needed pursuant to the foregoing, the auditor will thoroughly discuss the issue with contractor personnel authorized to make a decision. If resistance is met, the auditor will consult with the ACO, the cognizant Contract Audit Coordinator (CAC) or home office auditor (when assigned), and the regional office for advice and assistance in resolving the problem. Every effort should be made at this stage to resolve access problems on a case-by-case basis at the local level.

(h) If discussions fail to gain access, the auditor will submit a written request to the contractor. This request will include the reasons why access to the records in question is necessary. Also include a request that the contractor's reply be received, in writing, by a specified date. Information copies of the request should be sent to the auditor's regional director, the ACO, the appropriate PCOs, and the CAC or home office auditor if applicable. At this point, the regional office will promptly inform Headquarters, ATTN O, of the access to records problem.

(i) If the auditor does not receive a reply by the specified date, he or she should follow up with the contractor before proceeding further.

(j) If the auditor receives a timely reply from the contractor, either orally or in writing, that access to the records in question is still denied, before proceeding further, the auditor must be satisfied that (1) sufficient rationale has been provided the contractor, (2) the CAC or home office auditor has taken whatever action can be taken at the home office level if corporate policy is involved, (3) all efforts have been taken to settle the problem locally to avoid unnecessary escalation, and (4) the denial is significant in relation to the audit matter involved. Then, the entire file on the matter should be furnished to the auditor's regional director. The transmittal letter should refer to this paragraph and include a request for further guidance.

(k) The regional director should contact the contractor's top level of management, the PCO and ACO, and other Government personnel believed to be able to assist in obtaining the required records. Should the regional director be unsuccessful in efforts to obtain access to the records in question, the auditor should be provided guidance regarding the suspending or questioning of unsupported costs. Additionally, the ACO/Plant Rep should be formally requested to solve the problem. If the ACO/Plant Rep is unable to do so, he or she should be encouraged to advise each major PCO affected so that they may, when appropriate, elevate the problem to the appropriate level within the procuring department(s).

(l) The auditor should continue close coordination with the ACO/Plant Rep to remain currently informed on the status of the problem. The FAO should work closely with the ACO, PCOs and other procuring

Access to Records Policy
DCAA Contract Audit Manual

3-304.3 *Access to Contractors' Records*

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(c) It is incumbent upon DCAA auditors to use good judgment and reason in deciding what contractor records or other evidential material should be sought. The types of records needed by the auditor should be determined based on consideration of (1) the amount of Government business in relation to the total business of the contractor, and (2) the effect on the audit assignment. See 3-303.4 for additional guidance on access to contractor budgets, and 9-105.2 regarding cash flow forecasts.

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(e) Should the auditor find it necessary to initiate the actions set forth in paragraphs (g) through (l) below, the audit should not be interrupted if the available records will provide sufficient information upon which to base a usable report. However, when it is determined that a usable report can be issued, notwithstanding the contractor's denial, costs which cannot be supported due to unavailability of records should be questioned. In addition the "scope" paragraph of the report should be appropriately qualified. Costs under cost-reimbursement type contracts which are unsupported due to lack of access to records will be suspended in accordance with 8-303(a).

(f) In cases where the contractor's denial is so extensive that it is impractical to continue the audit, the activity requesting the audit should be promptly informed that the report cannot be furnished and the reasons therefor.

(g) When the contractor denies access to records needed pursuant to the foregoing, the auditor will thoroughly discuss the issue with contractor personnel authorized to make a decision. If resistance is met, the auditor will consult with the ACO, the cognizant Contract Audit Coordinator (CAC) or home office auditor (when assigned), and the regional office for advice and assistance in resolving the problem. Every effort should be made at this stage to resolve access problems on a case-by-case basis at the local level.

(h) If discussions fail to gain access, the auditor will submit a written request to the contractor. This request will include the reasons why access to the records in question is necessary. Also include a request that the contractor's reply be received, in writing, by a specified date. Information copies of the request should be sent to the auditor's regional director, the ACO, the appropriate PCOs, and the CAC or home office auditor if applicable. At this point, the regional office will promptly inform Headquarters, ATTN O, of the access to records problem.

(i) If the auditor does not receive a reply by the specified date, he or she should follow up with the contractor before proceeding further.

(j) If the auditor receives a timely reply from the contractor, either orally or in writing, that access to the records in question is still denied, before proceeding further, the auditor must be satisfied that (1) sufficient rationale has been provided the contractor, (2) the CAC or home office auditor has taken whatever action can be taken at the home office level if corporate policy is involved, (3) all efforts have been taken to settle the problem locally to avoid unnecessary escalation, and (4) the denial is significant in relation to the audit matter involved. Then, the entire file on the matter should be furnished to the auditor's regional director. The transmittal letter should refer to this paragraph and include a request for further guidance.

(k) The regional director should contact the contractor's top level of management, the PCO and ACO, and other Government personnel believed to be able to assist in obtaining the required records. Should the regional director be unsuccessful in efforts to obtain access to the records in question, the auditor should be provided guidance regarding the suspending or questioning of unsupported costs. Additionally, the ACO/Plant Rep should be formally requested to solve the problem. If the ACO/Plant Rep is unable to do so, he or she should be encouraged to advise each major PCO affected so that they may, when appropriate, elevate the problem to the appropriate level within the procuring department(s).

(l) The auditor should continue close coordination with the ACO/Plant Rep to remain currently informed on the status of the problem. The FAO should work closely with the ACO, PCOs and other procuring resolution of any access problems. Should the foregoing efforts prove unsuccessful or should there be a breakdown in the procedures for elevating the problem to the appropriate procurement levels, the regional director should submit a supplemental report to Headquarters for possible referral to higher levels.

(m) Pursuant to the foregoing, should the auditor either obtain access to the records in question or determine that further action is not warranted, the regional director and other addressees listed in (h), should be appropriately notified.

(n) Frequently, when reviewing a pricing proposal, time does not permit accomplishing all the procedures as set forth in paragraphs (g) through (l) above. In these cases, the auditor should quickly determine the extent of the contractor's denial and reaffirm the reasons why access to the records in question is needed. The formal request to the contractor provided for in paragraph (h) can be made orally, subsequently confirmed in writing, and the other parties noted in paragraph (h) can be contacted by telephone. When reviewing pricing proposals, the most effective means of obtaining access to needed records is by promptly referring the matter to the PCO for action as contemplated by DAR 3-807.6. Should the auditor be unsuccessful up to this point in attempts to obtain the needed records, the procedure set forth in paragraph (j) above should be accomplished by telephone. Similarly, the regional director's efforts, paragraph (k) above, may be accomplished by telephone. All actions accomplished by telephone should be confirmed by letter. When the regional director determines that the matter should be referred to Headquarters, the fastest means of communication available may be used, however, a brief written summary of the facts should subsequently be provided.

(o) Until essential budgetary data are obtained, it will be necessary to appropriately qualify advisory pricing proposal audit reports, as indicated in 10-302.3(b). The selection of the qualification statement from the examples listed should be based upon the situation existing at each contractor location in relation to each proposal at hand. A more moderate version should be selected in instances of partial denial where the effect is minimal, and a stronger version where there is a full denial or a critical partial denial.

(p) When records are alleged to have been destroyed, a written statement should be obtained from the contractor describing the circumstances. The extent to which an audit can be made on the basis of the remaining available records should be made known to the contracting officer. Reconstruction of contractors' records should not be attempted by the auditor. Any audit reports issued under these circumstances should contain appropriate comments on all the facts, with any necessary qualifications or explanations of costs questioned.

DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VIRGINIA 22314

IN REPLY REFER TO
PFD-18
4-00

23 FEB 1984

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA

SUBJECT: Access to Contractors' Records

In a recent oversight review of DCAA, the DoD Inspector General raised concern about whether effective action is being taken to gain access to contractors' records. We have reviewed the CAM guidance on this subject and concluded that it is adequate. Nevertheless, a discussion of that guidance seems appropriate to assure that it is being given sufficient attention.

As stated in CAM 1-206.3, auditors should promptly question and/or suspend cost amounts that are determined to be unsupported for lack of access to contractor records. There is no requirement that the contractor be given formal advance notice that costs are to be questioned or suspended, and no "waiting period" is appropriate after the auditor has determined the amounts of unsupported costs related to a denial.

DCAA auditors are expected to exercise good judgment in deciding which contractor records are relevant to audit requirements for sufficient evidence to support conclusions and recommendations. If access to such records is denied, the procedures in CAM 1-206.3(e) become operative, i.e., all costs to which the records are relevant should be suspended if allocated to cost-reimbursement contracts, otherwise the costs should be questioned. Following that action, the procedural sequence in CAM 1-206.3(f) through (l) should be pursued.

If an audit report is required on costs affected by the access denial, and the costs are significant, an adverse summary opinion would be appropriate. For example, in a pricing proposal review, the summary opinion should state, "Therefore, we do not consider the proposal to be acceptable as a basis for negotiation of a price . . ." (CAM 10-302.3(b)(10)).

Access to contractor records related to unclaimed costs arises as a requirement in the audit of compliance with Cost Accounting Standard 405, "Accounting for Unallowable Costs," which of course has been incorporated in all contracts subject to DAR Section 15, Part 2, cost principles. It is not possible to test compliance with provisions in this standard dealing with "directly associated costs" unless the auditor is permitted to examine at least a sample of unclaimed costs. Complete denial of those records should result in suspension or questioning of all costs which may be associated with unclaimed costs. For example, costs of accountants and attorneys claimed as overhead or G&A may be directly associated with expressly unallowable organization costs. Thus, those costs may not be accepted for payment by the Government without sufficient evidence to assure the auditor that unclaimed costs do not represent organization costs in which the accountants and attorneys were directly involved. In requesting access to contractor records related to unclaimed costs, the auditor should emphasize that the records are required for tests of costs which are claimed.

Regional office questions on this matter may be referred to Mr. Jack Hunt, Chief, Policy Formulation Division, phone (202) 274-7314/5/6.

FOR THE DIRECTOR:

Fred J Newton
FRED J. NEWTON
Assistant Director
Policy and Plans

DISTRIBUTION
C

MEMORANDUM EXPIRATION DATE 31 MARCH 1985

DEPARTMENT OF DEFENSE
OFFICE OF THE INSPECTOR GENERAL
WASHINGTON, D.C. 20301

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nd Oversight

MAR 9 1984

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Report on Oversight Review of the Defense Contract Audit Agency - Reporting of Fraud or Illegal Acts

This is our report on the review of the reporting of fraud or illegal acts by the Defense Contract Audit Agency (DCAA). This is the first in a series of three reports on an oversight review of selected aspects of DCAA operations. The oversight review was performed from July 1983 to November 1983. The review objectives were to evaluate the effectiveness and timeliness of DCAA policies and procedures for the reporting and referring of fraud or illegal acts to DoD investigative agencies.

While the scope of our review did not include an evaluation of DCAA's procedures, techniques, and training for fraud detection, we noted that DCAA had undertaken some significant initiatives to increase the awareness of its auditors to contractor fraud. These initiatives included the preparation of a correspondence training course on fraud; assignment of A senior auditor on a full time basis to the Defense Procurement Fraud Unit; inclusion of articles on fraud in the DCAA monthly newsletter to its employees; and publication of fraud indicators for defective pricing audits. Also, DCAA plans to publish pamphlets on audit fraud cases that will describe the manner in which the fraud was committed and the audit techniques used to detect the fraud. Further, DCAA had entered into a memorandum of understanding with DoD investigative agencies on the referral of fraud cases and audit assistance for fraud investigations. This increased emphasis on fraud awareness has undoubtedly contributed to an increase in fraud referrals. During the last 6 months, DCAA referred 59 potential fraud cases to DoD investigative agencies. This compared with 46 cases for the preceding 12 months.

We found that most of the fraud cases we reviewed were referred by DCAA Headquarters to DoD investigative agencies in a timely manner. However, our review indicated that additional opportunities existed to improve the preparation, processing, and control of suspected fraud cases. The results of our review are summarized below and the details are contained in Part II of the report.

Direct communication between DCAA field offices and DoD investigators earlier in the process should foster more timely and effective fraud referrals. Significant processing delays were noted for 20 of the 62 reports we reviewed. We believe that such communication would have eliminated the extended time involved in some of the past fraud referrals as well as a clearer understanding by DCAA auditors as to what constituted reportable fraud (page 4).

With the increased volume of fraud referrals a more formal records system is needed to control and monitor the processing of fraud reports. During our review we experienced difficulty in reconciling Headquarters and regional records and accounting for the disposition of all fraud reports prepared by regional offices that we visited (page 11).

Controls were needed to ensure that premature or inappropriate discussions were not held with DoD procurement officials on fraud cases to be referred to DoD investigative agencies. Clearance for such discussions should be obtained from the appropriate DoD investigative agency (page 14).

A draft of this report was provided to the Director, Defense Contract Audit Agency on February 2, 1984, for his review and comments. The comments provided by the Director in his memorandum of February 24, 1984, were considered in the preparation of this final report.

The Director indicated that actions had been taken or were in process to implement the recommendations on a tracking system for fraud cases (page 12) and requiring prior approval of DoD investigative agencies before holding discussions on fraud cases with DoD procurement officials (page 15). The Director proposed an alternative course of action for resolving whether two fraud reports should be referred to DoD investigative agencies (page 9). We agree with the alternative proposal.

On the remaining recommendation, the Director did not agree that changes were required in the implementing guidance for the Memorandum of Understanding with DoD investigative agencies (page 8). The Director was of the opinion that the brief written alert provision of the Memorandum of Understanding was working. Accordingly, he saw no need for an Agency-wide policy to encourage direct contact between DCAA field auditors and DoD investigators as soon as DCAA auditors had any indication of possible fraudulent acts. We still believe that early contact between DCAA auditors and DoD investigators would enhance the detection and investigation process for potential fraud cases.

The final position of the Director on recommendation A.1. should be provided to us within 60 days of the date of this report.

James H. Curry
James H. Curry
Assistant Inspector General
for Audit Policy and Oversight

REPORT ON OVERSIGHT REVIEW OF THE DEFENSE CONTRACT AUDIT AGENCY REPORTING OF FRAUD OR ILLEGAL ACTS

REPORT NO. APO 84-4

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REPORT ON OVERSIGHT REVIEW OF THE DEFENSE CONTRACT AUDIT AGENCY

REPORTING OF FRAUD OR ILLEGAL ACTS

PART I - INTRODUCTION

The review was made as part of our responsibility for overseeing and evaluating the Defense Contract Audit Agency's (DCAA) compliance with prescribed audit standards, policies, and procedures. The DCAA's mission is to perform all necessary contract auditing for the Department of Defense (DoD), providing accounting and financial advisory services to DoD procurement and contract administration activities for the negotiation, administration, and settlement of contracts and subcontracts. The DCAA also provides contract audit services to non-DoD Government agencies. The role of DCAA in providing these services is that of an independent advisor to the contracting officer. The DCAA is a separate agency of the DoD under the direction, authority and control of the Assistant Secretary of Defense (Comptroller).

Background

The DCAA Contract Audit Manual (CAM) and Comptroller General auditing standards provide that the auditor's primary function is not to detect fraud or other illegal activities, but that when fraud or other illegal activities are indicated, the auditor has a duty to promptly report them and expand the audit scope as necessary. The CAM states that DCAA auditors, upon encountering or receiving information which raises the suspicion of fraud or other illegal activity, will take immediate action to inform the appropriate DCAA regional office or Headquarters and promptly pursue the development of factual information. The basic DCAA policies and procedures for reporting fraud and other illegal activities are included in the following paragraphs of the CAM:

12-701 - Fraud or Other Unlawful Activities
12-703 - Violations of Anti-Kickback Statutes
12-704 - Non-Competitive Procurement Practices
12-708 - Suspected Illegal Political Campaign Contributions

The CAM 12-701 cases are the most common referrals. The CAM guidance is supplemented by directives from each of DCAA's six regional offices and DCAA Headquarters Instruction 5500.3, "Reporting Suspected Contractor Fraud and Other Irregularities to DoD Components and to Government Agencies."

Timely reporting of potential fraud is important to assure that prompt action is taken to preclude monetary loss. The impact on the Government is often not measurable by the direct benefit to the party committing the unlawful or irregular conduct, but by the potential for loss due to continued improper or unlawful influence in the procurement process. By failing to report fraud cases promptly, the loss to the Government continues and often cannot be recouped. Also, the ability of investigators to successfully conclude an investigation is decreased over time.

On May 4, 1983, DCAA signed a Memorandum of Understanding (MOU) with the four DoD criminal investigative agencies. The MOU provided guidance on the referral of suspected fraud or illegal acts to DoD investigators and provides for DCAA auditors to assist DoD investigators in the performance of formal criminal investigations.

During the four years ending June 30, 1983, DCAA referred 165 cases of suspected fraud or illegal acts to investigative organizations for possible investigation. The number of cases by years are included in Appendix A.

Objectives and Scope of Review

The announced objective of the review was to evaluate the effectiveness and timeliness of DCAA policies, procedures, and practices for the reporting of significant audit related problems that require actions by higher management levels. The objective was subsequently restricted to the reporting of fraud or illegal acts to investigative agencies.

This area was selected for oversight coverage based on our review of a preliminary investigation report prepared by the Office of the Special Counsel, Merit System Protection Board on allegations by a DCAA employee. Based on the information contained in the investigative report we selected three areas for oversight coverage to determine whether the operational problems alleged by the DCAA employee had broader or systemic implications. These included access to contractors' records, reporting of fraud or illegal acts, and the accuracy of reported savings resulting from DCAA audits. Our oversight reviews did not include an evaluation of the validity of specific instances alleged by the DCAA employee to the Office of the Special Counsel.

Our review covered referrals of suspected fraud or illegal acts by DCAA regional and field offices during the period from October 1, 1979 to October 31, 1983. Our field work began in July 1983 and was completed in November 1983. Appendix B is a listing of DCAA offices visited in the course of our review. We judgementally selected cases referred to investigators at DCAA Headquarters and reviewed the case files for the timeliness of referrals. We examined all cases reported by field offices visited by reviewing the related workpaper files. We attempted to trace the processing of the referral from the date first detected to its disposition by DCAA Headquarters.

Our report is qualified to the extent that we could not satisfy ourselves that all available documentation was provided to us. We were unable to determine if we received a complete and accurate listing of all fraud cases prepared by DCAA field offices and referred to DCAA Headquarters (see Section B, Part II of this report for further details on this matter).

PART II - RESULTS OF REVIEW AND RECOMMENDATIONS

A. Reporting of Suspected Fraud Cases

Increased communication between DCAA field offices and DoD investigators should contribute to more timely and effective fraud referrals. We identified 20 fraud cases where significant delays were encountered between the initial indication of possible fraud and the referral of the cases to DoD investigative agencies. Most of the delays were encountered in the field offices. Moreover, our review indicated that confusion existed among some DCAA field auditors as to what constituted a reportable case of suspected fraud. Existing DCAA procedures do not provide for communication between DCAA field auditors and DoD investigators until the formal fraud report is prepared. We believe that direct communication as soon as there is an indication of possible fraud would assist DCAA field offices in the more timely preparation and processing of fraud referrals.

Discussion

The DCAA Headquarters Instruction 5500.3, "Reporting Suspected Contractor Fraud and Other Irregularities to DoD Components and to Government Agencies," dated April 14, 1981, describes procedures and responsibilities for the reporting and monitoring of fraud cases in general terms. The DCAA field offices are required to prepare a report of suspected fraud or illegal acts detected during the performance of their audit work. All reports of potential fraud are to be sent by field offices to DCAA regional offices for review and approval. The region then forwards reports to DCAA Headquarters with its recommendations. The Operations Division, DCAA Headquarters and the Defense Legal Service (DLS) legal counsel then jointly decide on whether to refer the matter for investigation.

The procedure included in the above cited DCAA Headquarters instruction was modified on September 28, 1983 to recognize additional reporting requirements included in a memorandum of understanding (MOU) between DCAA and DoD investigative agencies (see Appendix C). The MOU was signed on May 4, 1983.

Timeliness of Referrals

The DCAA Headquarters provided us with a listing of 165 referrals for investigation. We reviewed 30 cases from this listing and found that in 7 cases, 60 days to one year had elapsed from the date of the field fraud report until referral to an appropriate investigative agency. We also reviewed 32 field office files and found 13 cases where extended delays had occurred between the first indication of fraud and the referral of the fraud case to DoD investigative agencies. We recognize that the delays in some cases could be partially attributed to the complexity of accounting issues involved in the fraud cases. But other factors contributing to the delays were the internal review and processing of fraud reports, improper classification of cases, and extensive deliberation as to whether a fraudulent act had or had not been committed.

Examples of the delayed referrals are discussed below:

o On May 4, 1983, the DCAA resident auditor at a major aircraft manufacturer issued a report alleging collusion between the local contract administration office and the contractor on spare parts pricing issues. The alleged collusion was not referred for investigation until October 1983, six months later. In the period from May to October 1983, the regional office and DCAA Headquarters attempted to research and resolve related procurement "systems" problems, however this should not have delayed the referral. The documentation available did not explain the reason for not making an immediate referral of irregular conduct. The region officially transmitted the May 4, 1983 report to DCAA Headquarters on September 27, 1983. The transmittal memorandum stated that it was "apparent" that the irregular conduct reported on May 4, 1983 should be referred. The DCAA Headquarters told us that since the matter was not officially referred to them until September 27, 1983, they had no basis for acting until then. Once the matter was referred they acted promptly. However, an advance copy of the resident auditor's report had been forwarded to DCAA Headquarters on May 18, 1983, by the Atlanta Regional Office.

o We also noted a June 23, 1983 CAM 12-701 report at the same resident office that was referred for investigation on July 29, 1983. The audit work paper file indicated that the resident office was aware of the suspected irregular conditions as early as November 7, 1982. The resident office did not issue its CAM 12-701 report to the region until eight months later (June 23), although a report was issued on March 9, 1983 to the local contract administration office, outlining the basic facts surrounding the referral.

o During the fall of 1982 DCAA became aware of purchas-ing irregularities at a contractor. The DoD procuring activity was notified in July 1982 of the suspected irregularities but did not notify DCAA. In November 1982, DCAA requested copies of the contractor's internal audit reports and other documenta-tion. DCAA received the internal audit report in January 1983 but was denied full access to other relevant data. In November 1983 the Regional office forwarded a formal report on the suspected fraud to DCAA Headquarters. The regional report did not explain the reasons for the delayed reporting, but did conclude that the improper contractor practices had resulted in higher contract costs to the Government.

Cases Not Referred

We noted two cases that were not referred to DoD investigative agencies. One of the cases was not referred due to the lack of evidence to defraud the Government and another was not referred based on information received from the Federal Bureau of Investigation (FBI). Based on our review of available information we have reservations as to DCAA's decision not to refer the two cases to DoD investigative agencies. The details on these two cases follow:

o At a major aircraft manufacturer, the resident auditor referred a CAM 12-701 report to the DCAA Chicago Regional Office on October 1, 1981, alleging excessive billings. The local DCAA auditors found that the contractor was procuring long-lead materials in excess of current contractual requirements in anticipation of future orders. The contractor was claiming these excess material costs in requests for progress payments under Government contracts not requiring the materials. The case was not referred for investigation, according to a DCAA Headquarters memorandum dated December 16, 1982, because it did not disclose any "intention to cheat." The memorandum indicated that the contractor contended that the procurement office had full knowledge of the excess funding and the DoD procurement office stated that the matter was a funding issue, not fraud. We believe the matter should have been referred for investigation since there was a reasonable basis to suspect irregular conduct. Auditors are not trained investigators and should leave the judgment of intent to investigative authorities.

- In May 1981, the Chicago Regional Office submitted a CAM 12-701 report to DCAA Headquarters dealing with labor mischarges, commingling of contractor costs, and over-applied burden costs. The report indicated that $7.2 million in mischarged costs had been identified to date. Reference was also made to an on-going investigation of the contractor by the FBI. Subsequently, in November 1982, the DCAA resident auditor informed the Chicago Regional Office that since submission of the initial CAM 12-701 report in May 1981, DCAA audits had continued to disclose very serious mischarging and allocation problems. The resident auditor concluded that matters still warranted referral to DoD investigative agencies. In September 1983, the DCAA legal counsel advised the Chicago Regional Office that it did not plan to refer the suspected fraud for investigation. We were informed by DCAA personnel that the decision not to refer the matter was because the Department of Justice had declined to prosecute the contractor after receipt of the FBI report. The exact scope of the FBI investigation and whether it covered all of the areas in the CAM 12-701 report is not known.

Implementation of MOU

The objective of the written alert provision of the MOU between DCAA and DoD investigative agencies was to promote the early and timely reporting of suspected fraud cases. However, the manner in which DCAA has implemented this provision of the MOU has severely restricted the extent of advance notification to DoD investigative agencies.

The MOU provides that a brief written alert will be forwarded to the applicable DoD investigative agency when the DCAA field auditors have a reasonable basis to suspect an illegal act was committed. According to implementing guidance a reasonable basis exists when the DCAA field office has prepared a formal fraud report and the report has been approved by a regional audit manager. Consequently, a written alert is not provided until the formal report is ready to be forwarded to DCAA Headquarters for referral to the headquarters of a DoD investigative agency. Under such reporting procedures the advance notification to DoD investigative field offices required by the MOU is essentially negated.

Other than the written alert, the MOU does not cover other contacts between DCAA and DoD investigators concerning the documentation or reporting of suspected fraud. Our review of fraud cases disclosed that several months could elapse between the first indications of possible fraud and the preparation of the formal fraud report and written alert. For this reason, we believe that significant benefits could accrue to both DCAA and DoD investigative agencies if earlier direct contact was encouraged between DCAA auditors and DoD investigators. Direct contact as soon as the DCAA field office has an indication of fraud should be of major assistance in the preparation of more timely and effective fraud reports. Additionally, savings in audit resources should also accrue from the investigators expertise in the decision to refer a case for investigation.

Our discussions with DCAA field auditors indicated a lack of clear understanding as to what constituted a reportable case of suspected fraud. The primary areas of concern dealt with the subject of intent and frequency. Some felt that it was necessary to prove intent to defraud the Government before a matter could be reported as fraud. This is normally difficult to prove without the use of investigative techniques and therefore, should not be the sole responsibility of the auditor. This confusion was further evidenced by the improper reporting of some fraud cases as merely unsatisfactory conditions and vice versa.

The auditor is an expert in accounting matters and the investigator is an expert in the investigation of fraud. The combination of these expertises is essential for the effective pursuit and investigation of potential fraud cases. The earlier in the process that there is dialogue between the auditor and investigator the better the interests of the Government are served. Moreover, DCAA auditors are not aware of all active investigations by DoD investigators. It is possible that situations will be encountered where DoD investigators have active investigations on the same or related areas identified by DCAA auditors. So early notification of the suspected fraud could be of significant interest or assistance to DoD investigators.

Recommendations

We recommend that the Director, Defense Contract Audit Agency:

1. Implement an Agency-wide policy that encourages direct contact between DCAA field audit office managers and DoD

field investigators as soon as DCAA auditors have any indication of possible fraudulent acts.

DCAA Comments

The Director, DCAA stated that the MOU with the brief written alert feature is working and meets the recommended direct contact with DoD investigators as soon as DCAA auditors have a indication of possible fraudulent acts. The Director further stated that the alert provision of the MOU were coordinated with the Chief, Procurement Fraud Unit, Department of Justice and that the Chief agrees that the MOU-type procedures are appropriate. Moreover, DCAA was of the opinion that the direct contact with investigators proposed by the Office of the Inspector General would result in additional audit effort rather than a savings in audit resources.

OAIG-APO Response

The above comments do not really address the intent or purpose of the recommendation. We have no disagreements with DCAA as to the need or value of the written alert provision of the MOU. The matter at issue is the manner in which the alert provision was implemented in a DCAA Headquarters memorandum dated September 28, 1983, and the ability of DCAA auditors to freely communicte with DoD investigators.

We believe that early contact between DCAA auditors and DoD investigators would enhance the detection and investigation process. The DoD investigators are the internal experts on fraud matters and know the types and extent of evidential matter required for the referral of matters for criminal prosecution. The DCAA auditors are not, and should not, be trained to be criminal investigators. Therefore, any consultation or assistance they can obtain from DoD investigators should be of major benefit to the DCAA auditors. We believe that a team approach to the detection, reporting and investigation of suspected fraud is essential for an effective DoD fraud program. We do not agree that direct contact with DoD investigators would necessarily result in additional audit effort. To the contrary, such contact should eliminate unnecessary audit work and enhance the investigative process rather than detract from it.

2. Review the circumstances surrounding the two fraud cases not referred for investigation to determine whether the cases should now be referred to DoD investigative agencies.

DCAA Comments

The Director, DCAA disagreed with this recommendation but indicated that DCAA personnel were available to discuss the facts if the Office of the Inspector General should so desire.

OAIG-APO Response

We will make arrangements to meet with DCAA and DoD investigators to make a final determination on the need for referral of the two potential fraud cases.

B. Controls Over Processing of Fraud Cases

Improved controls were needed over the receipt and disposition of fraud reports received by DCAA Headquarters from its regional offices. We experienced problems in reconciling records of fraud reports maintained by regional offices with information provided by DCAA Headquarters. The relatively low volume of fraud cases in the past may not have warranted the establishment of a formal records system to account for the receipt and disposition of fraud reports. However, we believe that with the increased number of fraud reports that such a formal system is now needed to insure the timely referral and tracking of the disposition of fraud reports.

Discussion

The DCAA Instruction 5500.3 does not prescribe any specific requirements for logging in referrals from the regions and systematically monitoring the disposition of referrals. The responsibilities for processing potential fraud cases are divided between the Operations Division, DCAA Headquarters and the legal counsel assigned to DCAA.

The Operations Division assigns a control number only to those cases referred for investigation. The legal counsel maintains a separate file for each case but does not assign a control number to any referrals from the field. Legal counsel is responsible for monitoring all cases referred for investigation. Moreover, there was no DCAA guidance on the procedures for DCAA regional offices to maintain control over the processing of fraud cases to DCAA Headquarters. One of the regions visited had no central record of fraud reports referred to DCAA Headquarters. Another region had a system where a control number was assigned to each report referred to DCAA Headquarters.

In our announcement letter for this review, we requested DCAA Headquarters to provide us a listing of all fraud reports received from the regional offices. A listing of 165 cases, prepared by the Operations Division, was provided to us. The listing was titled "Suspected Irregular Conduct Cases Referred For Investigation." Upon advising DCAA Headquarters personnel that this listing did not include all fraud referrals from the regions, we were informed that files maintained by the legal counsel were more complete than those maintained by the Operations Division. We subsequently requested a listing from the legal counsel. The listing provided by the legal counsel included over 490 entries regarding fraud matters referred to DCAA Headquarters for basically the same time period. The legal counsel's listing included all incoming fraud reports and related correspondence. It also included numerous documents or correspondence not directly related to fraud reports prepared by DCAA field offices.

We were unable to reconcile the two listings nor were we able to obtain a satisfactory explanation for the difference. Furthermore, we requested each region visited to provide us a listing of reports referred to DCAA Headquarters to determine that all reports were being properly reviewed and evaluated for investigative referral. We found that the data provided by the regional offices included reports that were referred for investigation but were not shown in the legal counsel listing. For example, the Atlanta region listed reports for two contractors which we could not trace to the legal counsel listing. We were satisfied from documentation in regional and/or field audit office files, however, that all these reports were referred to the investigators even though they were not shown in the legal counsel listing.

The lack of a sound system to monitor potential fraud cases could lead to untimely referrals or the lack of referral due to lost reports. Additionally, unless each report contains specific identifying report numbers, it becomes extremely difficult, if not impossible, to communicate on inquiries, status, or even original referrals with any degree of assurance that the proper case is being discussed.

Recommendations

We recommend that the Director, Defense Contract Audit Agency establish specific procedures of controlling and monitoring fraud referrals. These procedures should include a requirement for assigning control numbers to all suspected fraud reports and controlling of all related documentation using the assigned control numbers.

DCAA Comments

The Director, DCAA indicated that DCAA was in the process of establishing a singular headquarters system for numerically controlling fraud cases referred by the regions. Further, each regional office will be required to periodically furnish a listing of all referred fraud reports for reconciliation with records maintained by DCAA Headquarters.

C. Discussion Of Potential Fraud Cases with DoD Procurement Officials

Potential fraud cases involving DoD procurement officials were discussed with local contract administration or procurement officials prior to their referral to DoD criminal investigative agencies. Local DCAA auditors should obtain guidance and counsel from DoD investigators before any discussions are held on potential fraud cases with individuals assigned to DoD procurement or contract administration organizations. Premature disclosure of information could hinder or compromise any subsequent investigation by DoD investigative agencies.

Discussion

The DCAA Headquarters Instruction 5500.3, and CAM 12-701 provides guidance for reporting fraud cases. The CAM guidance requires discussions with procurement representatives or administrative contracting officers to explain the potential fraud and to arrange for any extension in the reporting dates for an audit affected by the conditions. The CAM 12-701.3 also states that all information must be protected to prevent premature release and disclosure to persons who may be party to the irregular conduct. This guidance does not, however, discuss procedures to be followed in fraud cases involving Government officials.

The above stated policy was reaffirmed in a memorandum issued on September 28, 1983, to implement the MOU with DoD investigative agencies. This memorandum states that it is important that the DCAA field office manager inform the Government plant representative or his deputy of the suspected fraud when releasing the formal fraud report to the DCAA regional offices. The memorandum does not provide for any exception to this policy.

We noted three instances where DCAA field office personnel briefed the local DoD contract administration or procurement offices of suspected fraud that involved personnel working in these offices. These three instances are discussed below:

- As previously noted in Section A, on May 4, 1983, a DCAA resident auditor reported suspected irregular conduct involving alleged collusive actions by the local procurement office and the contractor. Subsequent to the issuance of the report to the regional office, the regional director and other regional officials met with the local contract administration office. The meeting was held at the direction of DCAA Headquarters. The stated purpose of these discussions were to resolve system deficiencies contained in the report of May 4, 1983. On September 13, 1983, the regional office wrote the resident auditor asking if a potential fraud report was still warranted in light of the decision to work the issues locally. The resident auditor replied that he had not participated in the Headquarters and regional effort to work the issues, and the facts, as far as he knew, remained unchanged from his prior report. The region subsequently referred the case for investigation, and the resident auditor, in accordance with DCAA policy, briefed the local contract administration officials on the referral.

- We also noted two other instances, both alleging misconduct by local procurement officials, where the DCAA resident auditor, at the direction of his regional office, briefed the local contract administration office of the pending referrals. In one of the cases, the local contract administration officials, not suspected of the irregular conduct, apparently notified the procurement office that was suspected.

We believe that DCAA personnel should not discuss fraud cases, especially when local DoD procurement officials may be involved, with any outside individual until the issues have been discussed with DoD investigators. Informing DoD procurement officials prior to notifying DoD investigators could jeopardize or compromise the Government's case. It is possible that collusion could exist between DoD officials and the contractor without the knowledge of the DCAA auditors.

Recommendation

We recommend that the Director, Defense Contract Audit Agency revise its policy and field guidance to specifically preclude the discussion of potential fraud cases with DoD procurement officials unless approval is obtained from the cognizant DoD investigative agency.

DCAA Comments

The Director, DCAA stated that guidance on this matter was provided to the regional directors on February 15, 1984. The guidance requires coordination with the applicable investigative agencies prior to notification of Government plant representatives. A copy of the guidance is included as Appendix D.

OAIG-APO Response

We agree with the new guidance except that we believe DCAA should require a positive response from the DoD investigative agency.

SUSPECTED FRAUD OR ILLEGAL ACTS
REFERRED TO INVESTIGATIVE AGENCIES
PERIOD OCTOBER 1, 1979 - JUNE 30, 1983

Year Ending June 30	Number of Cases
1980	50
1981	30
1982	39
1983	46
TOTAL	165

APPENDIX A

REGIONAL AND FIELD OFFICES VISITED

Atlanta Region

- Bell Helicopter Textron Resident Office, Fort Worth, TX
- General Dynamics--Fort Worth Resident Office, Fort Worth, TX
- Harris Corporation Resident Office, Palm Bay, FL
- Lockheed-Georgia Company, Resident Office, Marietta, GA
- Texas Instrument Inc., Resident Office, Richardson, TX

Boston Region

- AVCO Corporate-Lycoming Division Resident Office, Stratford, CT
- Boston Branch Office, Boston, MA
- Bridgeport Branch Office, Bridgeport, CT
- Farmingdale Branch Office, Farmingdale, NY
- GE-Lynn Resident Office, Lynn, MA
- General Dynamics Electric Boat Resident Office, Groton, CT
- Grumman Aerospace Corporate Resident Office, Lexington, MA
- Raytheon Company Equipment Division Resident Office, Lexington, MA
- UTC Sikorsky Aircraft Division, Resident Office, Stratford CT
- Waltham Branch Office, Waltham, MA

Chicago Region

- Chicago Suboffices Branch Office, Chicago, IL
  - Northrop-Defense Systems Division Suboffice,
  - Sundstrand Corporation Suboffice
- G.D. Land Systems Inc., Resident Office, Troy, MI
- McDonnell Aircraft, Resident Office, St. Louis, MO
- McDonnell Douglas Corporate, Resident Office, St. Louis, MO
- Pittsburgh Suboffices Branch Office, Pittsburgh, PA
  - Rockwell Home Office Suboffice,
  - Westinghouse Headquarters Suboffice,
- St. Louis Branch Office, St. Louis, MO
  - Emerson Electric Suboffice
  - G.D. Corporate Suboffice

Los Angeles Region

- Hughes/El Segundo, Resident Office, Los Angeles, CA
- McDonnell Douglas, Resident Office, Huntington Beach, CA
- Northrop Corporate, Resident Office, Hawthorne, CA
- San Diego Branch Office, San Diego, CA

MEMORANDUM OF UNDERSTANDING

Parties: The parties to this Memorandum of Understanding are the Defense Contract Audit Agency (DCAA) and the Air Force Office of Special Investigations, the Naval Investigative Service, Army Criminal Investigations Command, and the Office of Assistant Inspector General for Investigations DoD/Defense Criminal Investigative Service.

Scope: This Memorandum of Understanding specifies the procedures which will be used by the parties when contract audit support is requested for a criminal investigation into suspected fraud or other suspected irregularity on the part of a Government contractor, grantee, or an official or employee thereof. This Memorandum of Understanding also describes the procedures by which DCAA will alert a DoD investigative organization of a suspected contractor irregularity.

Background: Under a longstanding policy, DCAA renders comprehensive contract audit support to an investigative organization looking into a suspected fraud against the Government or a similar suspected irregularity on the part of a contractor. The scope and frequency of this audit support is increasing sustantially due to the increased attention being given to fraud and waste in Government programs.

Although the contract auditor does not have as his primary mission the detection of suspected fraud on the part of a contractor, the contract auditor is always on the alert for circumstances that may be indicative of wrongdoing.

Upon the detection of a reasonable basis for suspecting the existence of fraud or other irregularity, the auditor will report the matter through DCAA channels for referral to an investigative organization as set forth in the paragraph hereinafter captioned "Notification to Investigative Field Units of Suspected Frauds Detected During Contract Audit." Due to the complex auditing and accounting concepts that are frequently involved in audit-detected contract irregularities, the criminal investigation of audit-detected irregularities will usually require contract audit support.

The procedures set out below for servicing the investigative organization are designed with two principles in mind. The first principle is that the investigators will receive prompt and effective support from the contract auditors. The second principle is that this support will be furnished in a manner that is consistent with the contract auditor's role in the acquisition process. In obtaining such support, investigators will usually obtain the identity of individuals knowledgeable of the matter under investigation from the Field Audit Office Chief. However, this would not preclude the investigator exercising his/her judgment in contacting other DCAA field personnel to further an investigative interest. Where actual contract audit assistance is required, the procedures outlined in the next paragraph will govern.

Submission of a Request for Contract Audit Assistance. Contract audit assistance may be requested by any level of supervision or management of a DoD investigative organization. The request will be in writing and will be addressed to the corresponding level of DCAA supervision or management. The letter should identify the matter under investigation and specify functional tasks which are appropriate for accomplishment by contract audit. The local DCAA office is available to assist the investigators in developing a description of audit tasks. Any expansion of the original request for audit assistance may be made by the investigative agency to the assisting DCAA office.

DCAA Action on a Request for Contract Audit Assistance. DCAA will arrange for continuing operational control and supervision of the assigned auditor(s) by audit management. In this way, the investigative effort benefits from the totality of the Agency's resources and organizational structure and recognizes that the audit support is furnished to the investigators by DCAA, not merely by the individual auditors.

Selection of the Auditor Who will Assist in the Investigation. DCAA will give careful consideration to the investigator's preference when designating a contract auditor to perform audit tasks in support of an investigation. In addition, however, audit management must also consider such factors as the level of expertise required for the audit tasks, the staffing needs of other high priority assignments, the mobility status of the selectee, and the selectee's career development requirements.

Notification to Investigative Field Units of Suspected Frauds Detected During Contract Audit. The DCAA will provide a brief written alert to the investigative field unit designated to exercise investigative cognizance over a contractor plant or facility when the auditor has a reasonable basis to suspect a contractor irregularity. Alerts will be issued promptly by the head of the lowest DCAA organizational level (field office or suboffice chief). Cognizant investigative units will be determined as follows:

a. Contracts administered by DLA-DoD/OAIG-Investigations;

b. Contracts administered by Navy-NIS;

c. Contracts administered by Air Force-AFOSI; and

d. Contracts administered by Army-Army CID.

Copies of any written referrals issued after the initial alert will be provided by DCAA to the cognizant investigative unit. In addition, copies of referrals on audits involving b. through d. will be provided to DoD/OAIG-Investigations.

The cognizant investigative unit will advise the DCAA office issuing the initial alert whether an investigation has been opened and provide any information concerning the status of the open investigation as requested by DCAA and not prohibited by law.

Reporting of Non-Audit Related Allegations. The DCAA will alert the designated field investigative unit of allegations concerning wrongdoing that have no contract audit implications in the same manner as set forth in the previous paragraph.

Providing Information in Situations Other Than Active Investigations. When the investigator seeks to obtain information concerning a contractor, such information normally will be obtained from the Contract Administration Office (CAO). In the event that CAO cannot provide sufficient data concerning contract audit matters, the investigator will direct his questions to DCAA.

Exceptions. It is recognized that special circumstances or the urgency of a given situation may militate against compliance with the terms of this Memorandum of Understanding. When such circumstances are perceived, the Director, DCAA, the head of the investigative organization or principal subordinates will follow a mutually acceptable alternate arrangement. These exceptions, however, are expected to be few.

Executed this 4th day of MAY 1983.

Major General Paul M. Timmerberg
Commanding General
U. S. Army Criminal Investigation Command

P. D. Hoskins, Captain, USN
Director
Naval Investigative Service Headquarters

Brigadier General Richard S. Beyea, Jr.
Commander
Air Force Office of Special Investigations

Brian M. Bruh
Acting Assistant Inspector General for Investigations DoD/Director, Defense Criminal Investigative Service

C. O. STARRETT, Jr.
Director
Defense Contract Audit Agency

DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VA 22314

REPLY REFER TO
OAD-9
702.1.10

15 FEB 1984

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA

SUBJECT: DCAM 12-701.4(a)(5) Reporting Procedures

A Headquarters MFRD (00-62) dated 7 June 1983, same subject, reemphasized the importance of notifying the Government Plant Representative or the Deputy, of audit findings associated with a CAM 12-701 report. To enhance the process, please establish procedures for notifying the Government Plant Representative or the Deputy of "brief written alerts" whenever they are provided to the investigative organization regarding suspected fraud or other unlawful activity. The "brief written alert" will be sent to the cognizant investigative field unit by registered mail with return receipt requested and should state that unless advice is received to the contrary within 5 working days, notification of the "brief written alert" will be provided the Government Plant Representative. This notification will be provided in all but the following two circumstances:

1. Where it appears that the Plant Representatives may be involved. (In this situation, the Regional Audit Manager will inform Headquarters O or DL who will provide advice as to what action is necessitated.)

2. We are specifically instructed by the investigating or prosecuting organizations to withhold any notification of the "brief written alert" to Plant Representatives.

We expect there will be very few instances where the Plant Representative or the Deputy would not be notified through the "brief written alert" system.

FOR THE DIRECTOR:

Ray E. Logsdon
RAY E. LOGSDON
Assistant Director
Operations

Distribution:
B

MEMORANDUM EXPIRATION DATE: 31 January 1985